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Dobrescu, Emilian  
Romanian Academy

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## Macromodel of the Romanian Market Economy (Version 2005)\*

Emilian Dobrescu\*\*

**Abstract** The macromodel will be used to investigate short and medium-run economic implications of internal policies and of changes in the international context.

This new version of the Romanian macromodel benefits from the experience gained by the author during the utilisation of its previous forms - either experimental (tested during 1991-1995) or operational (developed during 1996-2003). At the same time, this model introduces some methodological and informational improvements, in comparison to previous versions.

The most significant of them is the structural decomposition of economy, according to the input-output techniques. Output and absorption are divided into: a) agriculture, sylviculture, forestry, hunting, and fishing; b) mining and energy; c) manufacturing industry; d) construction; e) transport, post and communications; f) trade and services. These categories can be easily translated into the classical three-sectors classification: primary (a+b), secondary (c+d), and tertiary (e+f).

Due to the relatively advanced stage of the transitional processes in Romania, the behavioural functions were modelled - as much as possible - by the standard relationships. Besides, unlike the previous versions, that used statistical series beginning with 1980, the present one is based exclusively on information regarding the period 1989-2004. Therefore, we have considered more adequate to name this variant the macromodel of the Romanian market (not transition, as before) economy.

Since the input-output tables are defined yearly, the model contains only annual indicators. They are expressed in denominated local currency (RON). When there were several informational sources for the same indicator, we preferred the data extracted or derived from national accounts.

The statistical series are relatively short and often fractured (because of the transforming processes of transition). Although, it is known that ADF test of stationarity does not offer reliable results in the case of limited number of observations, generally the series satisfying it were used. The Granger causality test was computed for one, two, and three lags. The simplest methods of estimation were also preferred. The structural breaks in the evolution of some indicators have been dealt by the inclusion of dummies. Obviously, all these circumstances weaken the stability of econometric coefficients that must be continuously updated. The main relationships are grouped in seven sections: input-output block; labour market, production function; domestic absorption, foreign trade, prices and exchange rate, and interest rate.

The first two chapters present conceptual framework of macromodel and econometric analysis on which it is based. The next one describes a possible scenario for the Romanian economy during 2005-2010 years. The final part of paper contains a set of simulations revealing some operational features of the macromodel.

**Key-words:** model, input-output analysis, econometric relationships, simulations

**JEL Classification:** C5, E2-E6, H6

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\*\*Senior researcher, member of the Romanian Academy

Address: Str. Uruguay Nr. 2, Bl. 8, Ap. 2

011445 Bucharest, Sector 1 - Romania

Tel.: 0040 21 222 28 50, Fax: 0040 21 411 93 38

e-mail: edobrescu @ rdslink.ro

### Content

### Abstract

### Chapter I: Conceptual Framework

A. Introduction

B. Main Behavioural Relationships

### Chapter II: Econometric Analysis

A. Input-Output Block

B. Labour Market

C. Production Function

- D. Domestic Absorption
- E. Foreign Trade
- F. Prices and Exchange Rate
- G. Interest Rate

### **Chapter III: Main Scenario for 2005-2010 Years**

- A. Computational Hypothesis
- B. Simulation results

### **Chapter IV: Responses to Changes of Exogenous Indicators**

## **Chapter I Conceptual Framework**

### **A. Introduction**

The author's works devoted to the Romania's transition from command economy to market mechanisms have developed in connection with the activity of the Macromodelling Seminar, organised and coordinated by him at the National Institute for Economic Research. As a result, a set of special macromodels have been elaborated.

Several experimental variants were tested during 1991-1995 (Dobrescu 1991-1994). The debates initiated in that period by the institutes of the Romanian Academy, the Bucharest economic faculties, the General Association of Romanian Economists, and the Romanian Economic Society constituted an exciting environment for these works. The commentaries of M. Lord (Boye-Lord International Ltd., Washington D.C.) and F. Barry (University College Dublin), who examined some of these preliminary trials have also been highly useful.

1. The first operational version (Dobrescu 1996) was finalised after author's visit at the Hoover Institution, when he had the opportunity to discuss the transition and modelling problems with J. Taylor, I. Adelman, E. Lazear, J. Raisian, M. Bernstam.

This version, as well as the following ones, took into consideration the peculiarities of transition economies, which can be regarded, at least in the case of Romania, as a weakly structured system (from an institutional point of view). This state is characterised by several features:

- for relatively long period, the property rights are not clearly defined;
- the economic life is also marked by a mixture of old and new rules;
- the discretionary intervention of public authorities is substantial and submitted to random political interests;
- the formal institutions are incomplete and soft, but the informal ones have an important role in the economy and society.

Under such circumstances, the modelling problems are very complicated. The theoretical standard assumptions must be correspondingly accommodated. At the same time, the econometrics has to be based on unreliable statistical series.

The main relationships of the 1996 operational version of the macromodel referred to: real output, consumption, investment, foreign trade, labour force, labour productivity, exchange rate, price indices, labour income, general consolidated budget, interest rate, and other monetary variables.

The real output was estimated separately for the following five sectors: a) industry and construction; b) agriculture, forestry, hunting and fishing; c) transport, post and communications; d) public services; and e) trade, banking and other services.

Beginning with this version, the National Bank of Romania used the estimations, generated by this macromodel, for analytical investigations and forecasts.

2. The second operational version of the macromodel (Dobrescu 1997) has included some substantial changes:

- the introduction of a special block for demographic variables (population, population over 15 years, labour force, retired people);
- the connection of the annual indicators to a monthly block for the evolution of export and exchange rate;
- the aggregation of the previous five sectors into three, namely: a) industry, construction and agriculture; b) transport, communications, trade, banking and other services; c) public services.

The 1997 version took into account valuable suggestions by W. Charemza (Leicester University), S. Hall (Imperial College and London Business School), and J. W. Velthuisen (University of Amsterdam).

C. Ciupagea, C. Scutaru, and P. Fomin published quarterly and monthly predictions using the 1997 model and later versions [Microeconomia Aplicata, CEMATT S.A., Bucharest; Internet Securities ISI Emerging Markets Inc. Boston, US; Romanian Journal of Economic Forecasting, Romanian Academy].

3. The third operational version of the macromodel (Dobrescu 1998) has modified the previous one through:

- a more relevant determination of the expected income of households, firms, and general consolidated budget;
- a delimitation of the most important consequences of the budget deficits;
- a more detailed elaboration of the possible scenarios concerning the future evolution of Romanian economy, depending on internal macroeconomic (especially structural) policies and international environment.

The interesting suggestions formulated by J. Bradley (Economic and Social Research Institute of Dublin) have been introduced into Romanian macromodel.

4. The fourth operational version (Dobrescu 1999) was characterised by the following main changes:

- the determination of the real output for the entire economy, without branch division;
- the estimation of the main components of the domestic aggregate demand (absorption) using econometric relationships;
- the determination of export using exclusively relationships reflecting the market conditions, the influence of the historical trend being abandoned.
- the use of the bootstrap techniques.

This version has been examined at the 1999 Fall Meeting of the International LINK-Project.

5. The fifth version of the macromodel (Dobrescu 2000) improved the previous one, introducing relationships concerning foreign direct investment, non-reimbursable foreign loans (received first of all from European Union), public debt and total external debt.

This variant has been used for the elaboration of the “Romania’s medium term economic strategy” for integration into European Union.

It was divided into three main blocks:

- output and absorption (aggregate demand),
- production factors and labour income, and
- financial and monetary variables.

This version continued to operate preponderantly with annual indicators. However, in the following cases, either annual or monthly ones were involved: consumer price index, monetary base, exchange rate, export, and import. C. Ciupagea and G. Turlea added a block for the foreign trade, disaggregated according to the SITC LINK classification.

The 2000 version of the Romanian macromodel has been updated during 2001-2004. Its estimations were used for the elaboration of successive yearly “Pre-Accession Economic Programmes” of Romania (Dobrescu 2002a, 2002b, 2003, 2005).

The series of the 1996-2000 operational variants of the macromodel has been awarded in 2001 The Special Prize of the National Bank of Romania,

6. The present version incorporates the experience accumulated through the utilisation of previous forms. At the same time, it introduces some important methodological and informational changes.

6.1. The most significant of them is the reverse to the structural analysis. Unlike the previous forms, now such decomposition is associated with input-output techniques. This approach became possible as a result of the remarkable efforts of the Romanian National Institute for Statistics to compute the respective tables for the entire period 1989-2001. Being the first such attempt, a reduced number of sectors have been preferred. Consequently, the output and absorption are divided into six sectors, namely: a) agriculture, sylviculture, forestry, hunting, and fishing; b) mining and energy; c) manufacturing industry; d) construction; e) transport, post, and communications; f) trade and services.

They are computationally interconnected through input-output coefficients, derived from extended tables for 105 branches.

The adopted structure can be easily translated into the classical three-sectors classification: primary (a+b), secondary (c+d), and tertiary (e+f).

6.2. Due to the relatively advanced stage of the transitional processes in Romania, the behavioural functions were modelled - as much as possible - by the standard relationships. Besides, unlike the previous versions, that used statistical series beginning with 1980, the present one is based exclusively on information regarding the period 1989-2004. We have considered, therefore, more adequate to name this variant **the macromodel of the Romanian market (not transition, as before) economy**.

6.3. The model contains only annual indicators since the input-output tables are defined yearly. They are expressed in denominated local currency (RON). The export, import, and exchange rate series were transformed in Euro, taking into account the importance of the European Union countries in the Romanian foreign trade and the integration processes.

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## B. Main Behavioural Relationships

Regarding behavioural relationships, the present version of model has retained those specifications which:

- a) are consistent with standard macroeconomic theorems;
- b) correctly describe the peculiarities of the Romanian market economy;
- c) generate plausible results in simulations.

They refer first of all to labour market, output, domestic absorption, foreign trade, prices, exchange rate, and interest rate.

1. The market mechanisms penetrated slower in the interaction of labour supply-demand. Nevertheless, step-by-step they became again dominant in this field.

As it is known, the macromodelling research dedicated to these problems are characterised by several explanatory approaches. Concerning labour force dynamics, the changes in output (different variants of the so-called Okun's law) or in aggregate demand are frequently invoked; the trend of employment is also referred to [Holden; Jula and Jula; Scheneider, Hofreither, and Neck; Artus and Bismut; Kawasaki; Chung; de Bondt, van Els, and Stokman; Mattei; Christ; Fair; Gaburro (1985, 1986); Fidrmuc and Pichelmann; Olexa, Holuska, Orsagova, Klein and Sasinek; Abel and Bernanke; Naohiro, Akira, Makoto, and Mitsuo; Stockhammer; Jahnke et al; Layard, Nickell, and Jackman; Elmeskov and Pichelmann; Elmeskov; Malcolm, Kerrison, and Menzies]. Labour demand (employment) is correlated in many models with the change in the unit labour cost [Belot and van Ours; Scheneider, Hofreither, and Neck; Naohiro, Akira, Makoto and Mitsuo; Verbeek]. Some researchers approximate it using its dependence on utilisation rate of productive capacity, unemployment inertia, number of vacancies in the economy [van Miltenburg (1997a, b), Lahti, Spanikova; Elmeskov]; According to Elmeskov and Pichelmann, "The data...point towards a negative long-run relation – both in levels and in changes – between unemployment and labour-force participation, suggesting that with rising open unemployment its <hidden component> may increase as well."(p.11). Regarding the wage equation, the literature insists, as explicative factors, on unemployment, labour productivity, tax „wedge”, different indices of inflation [Logeay and Tober; Blanchard and Katz; Nymoen; Holden and Nymoen; Johansen; Holden; Whelan; Bradley and Morgenroth; Fidrmuc and Pichelmann; Brunia; Karbuz; Olexa, Holuska, Orsagova, Klein and Sasinek].

For the Romanian economy, three relationships have been selected: the labour force participation rate, the unemployment, and the nominal labour income per employed person.

1.1. The labour force participation rate (prap) – as a ratio of labour force to population over 15 years - is defined depending on employment (E) in previous period.

1.2. Such sluggishness is also present in the case of unemployment rate (ru). In addition, it appears to be mainly influenced by the evolution of unit labour cost (ULC), determined as a ratio between the labour income and the labour productivity.

1.3. With respect to the nominal labour income per employed person, two explicative factors seem to be essential: the unemployment rate and inflation.

These relationships generate, also for the Romanian economy, standard slopes of the labour supply and labour demand (as a function of labour income per employed person).

2. The below proposed production function tries to combine the classical framework with the recent modelling approaches [Aghion and Howitt; Apel and Jansson; Banca d'Italia; Baxter and King; Blanchard; Burnside, Eichenbaum, and Rebelo; Cechetti; Claus (2000a, b); European Commission 1995 and 2000; Eurostat 1999; Forni and Reichlin; Gerlach and Smets; Gordon (1997 and 2000); Griliches (1994 and 1996); Hodrick and Prescott; Hulten; Kuttner; Nordhaus; OECD 2000; Prescott; Schreyer; Scott; Solow; Turner, Richardson, and Rauffet; Gundlach; Kawasaki; Iancu; Ekstedt and Westberg; Pindyck and Rubinfeld; Artus, Avouyi-Dovi, and Laffargue; Nemenyi; Froyen; Bradley and Morgenroth; Allen; Harvey; Denis, Mc Morrow and Röger; Elmeskov; Proietti, Mussoy, and Westermanny]. At the same time, certainly, our attempt takes into account the main peculiarities of the Romanian economy in order to obtain, as relevant as possible, the estimation tools.

2.1. The usual production function with capital and labour is adopted.

The capital is interpreted in its largest sense, including here not only technological equipments and direct productive buildings, but also infrastructure and other tangible fixed assets, taking into account that all of them influence the performances of the economy. We maintain the assumption that the production function may include the real capital stock as such, without corrections derived from a disputable (and not clearly defined) normal utilization rate. Since the tangible fixed assets were estimated using indirect methods, they will be named "conventional tangible fixed assets".

As in other similar approaches, the share of labour income in gross value added will approximate the coefficient alpha; this includes officially registered labour income (alpha1) and other revenues generated by the economic activities of the households (production for self-consumption etc).

2.2. Two categories of variables are important determinants of the total factor productivity: the level of alpha itself and, on the other hand, several indicators, which essentially influence the technologies and the utilisation rate of the productive capacities.

Regarding the first factor, it seems realistic to assume that:

- when actual alpha is less than its long-run (equilibrium) level, the labour force is not stimulated to reach the highest potential output;

- conversely, if alpha surpasses such an optimal level, the firms are obliged to restrain their activity, which has also negative repercussions on total factor productivity.

Starting from these considerations, the econometric relationship of the index of total factor productivity (ITFP) will be built corresponding to the following restrictions:

- if  $\alpha=0$  or  $\alpha=1$  (that is when the production would be nonsensical for the labour force or, respectively, for capital), ITFP tends to zero;
- ITFP depends non-linearly on alpha, admitting a maximum when alpha is equal to its long-run (equilibrium) level.

We suggest the simplest functional form for ITFP which incorporates these conditions into econometric specification:

$$ITFP = (\alpha - \alpha^a) \cdot RV$$

where RV captures the effect of the rest of the variables.

The first adopted assumption (when  $\alpha=0$  or  $\alpha=1$ ,  $ITFP=0$ ) is automatically observed.

The second one is also satisfied for  $a>1$ . The question is: How to determine parameter a?

The long-run (equilibrium) level of alpha will be noted  $\alpha_{fao}$ . It is estimated separately using a specific procedure. From

$$\partial ITFP / \partial \alpha = 0 \quad (I.B.2.1)$$

we have:

$$1 - a \cdot \alpha_{fao}^{(a-1)} = 0 \quad (I.B.2.2)$$

$$1/a = \alpha_{fao}^{(a-1)} \quad (I.B.2.3)$$

$$(1/a)^{1/(a-1)} = \alpha_{fao} \quad (I.B.2.4)$$

If such an approach proves correct, it would be interesting to investigate in the future its similarities and differences versus standard output-gap theorem [Akerlof, Dickens, and Perry; Ball; Bårdsen and Nymoen; Baxter and King; Betcherman; Beveridge and Nelson; Blanchard and Katz; Blanchflower and Oswald; Claus (2000a, b); Cochrane; Conway and Hunt; Denis, Mc Morrow, and Röger; Doménech and Gomez; Elmeskov and Mac Farlan; Estrella and Mishkin; Evans; Gerlach and Smets; Giorino, Richardson, Roseveare, and van der Noord; Gordon (1996, 1997); Guarda; Herz and Röger; Holden; Kichian; Kuttner; Layard, Nickell, and Jackman; Logeay and Tober; Nymoen; Proietti, Mussoy, and Westermanny; Rennison; Rõõm; Staiger, Stock and Watson; Stiglitz; Stockhammer].

3. The main component of domestic absorption is, certainly, the private consumption.

3.1. Usually, the macromodelling practice relates absorption to the current income. In general, disposable income is used instead [Lord; Malinvaud; Duesenberry; Neck and Matulka; Fidrmuc and Pichelmann; Klein and Goldberger; Dombrecht; Brunia; Jahnke et al; Kawasaki; de Bondt, van Els, and Stokman; Ekstedt and Westberg; Karbuz; Bergstrom, Nowman, and Wandasiewicz; Christ; Fair; Adams and Dixon; Kinoshita; Gaburro (1985, 1986)]. Sometimes, the disposable income is replaced by wages [Ros Bosch; Spanikova; Artus and Bismut; van Miltenburg (1997a, b)], gross national product [Furno; Denton and Oksanen] or gross domestic product [Chung; Eu and Semudram; Kinoshita; Fair]. As explanatory variables for private consumption, different components of wealth are used [Klein and Goldberger; Dombrecht; Brunia; Paleologos; Galli, Terlizze, and Visco; Kawasaki; Chung; Morishima and Saito; de Bondt, van Els, and Stokman; Grimes, Spencer, Duggan, and Dick; Ekstedt and Westberg; Fair; Campbell; Gaburro (1985, 1986); Artus and Bismut].

The present version of the Romanian macromodel will also use the disposable income in the determination of private consumption. Taking into account the available information, disposable income is approximated by the sum:

$$YD = GDP - (BR - TR) + NOCAE \cdot ERE \quad (I.B.3.1)$$

where:

YD – disposable income, billion RON,

GDP – gross domestic product, current prices, billion RON,

BR – general consolidated budget revenues, billion RON,

TR - government transfers, billion RON, including consolidated budget expenditures for social protection (pensions, unemployment benefits, social assistance) and labour income of public sector workers,

NOCAE - net incomes and current transfers, billion Euro,

ERE – exchange rate, RON per Euro.

3.2. The interest rate is also implicit in the estimation of the private consumption [Lahti; Kawasaki; Furno; de Bondt, van Els, and Stokman; Ekstedt and Westberg; Bergstrom, Nowman, and Wandasiewicz; Fair; Adams and Dixon; Kinoshita; Gaburro (1985, 1986); Artus and Bismut]. The effect of interest rate on consumption is however contradictory. "Irving Fisher's model shows that, depending on the consumer's preferences, changes in the real interest rate could either raise or lower consumption" (Mankiw 1994, p.402). The analysis of the Romanian series revealed, nevertheless, a negative correlation between private consumption in real terms, on one hand, and the interest rate, on the other.

3.3. Many macromodels introduce one or several lags [Lord; Klein and Goldberger; Malinvaud; Duesenberry; Neck and Matulka; Fidrmuc and Pichelmann; Dombrecht; de Bargañca, Figueiredo, and Rato; van Miltenburg (1997a, b); Lahti; Brunia; Paleologos; Jahnke et al; Kawasaki; Chung; Furno; Elabbassi; Spanikova; Palmer and Palme; Kinoshita; Karbuz; Bergstrom, Nowman, and Wandasiewicz; Fair; Denton and Oksanen; Campbell; Kinoshita; Gaburro (1985, 1986); Artus and Bismut]. The proposed version of Romanian macromodel also includes the previous level of private consumption as an explanatory variable of the current one.

3.4. Depending on the peculiarities of studied economies, some authors include - among causal factors of private consumption - the exchange rate [Artus and Bismut], the employment effect [Hasselman, Post, and van der Beld; Ekstedt and Westberg], and other indicators.

In the Romanian case, such variables seem to be irrelevant, and, consequently, they will not be taken into consideration.

4. Modelling researchers relate public consumption to different explanatory variables: gross national product or global output [Serry; Hughes-Hallett and Petit; Petit], national income [Arif and Rangarjan], budget expenditures [Neck and Karbuz], budget revenues and deficits [Fukuchi, Imagawa, Oguchi, Ohno, Takenaka, and Tokunaga; Vargas; Sarpong; Pandit], population [Rao and Azhar; Sarpong; Pandit], employment and wages in government sector [Cordina], lagged public consumption [Fukuchi, Imagawa, Oguchi, Ohno, Takenaka, and Tokunaga; Sarpong; Arif and Rangarjan].

We approximate the public consumption in relation with the government budget expenditures. This is interpreted as a general consolidated budget, which includes the state budget, the local budgets, the social insurance budget, and other similar funds; all of them exert income redistribution functions regulated by authorities.

5. Investments are, often, correlated with the stock of capital [Klein in Pindyck and Rubinfeld; Nemenyi; Scheneider, Hofreither, and Neck; Barten and Dhaene; van Miltenburg (1997a, b); Lahti; Brunia; Hughes-Hallett and Petit; Gandolfo and Padoan; Galli, Terlizzese, and Visco; Kawasaki; Chung; Ros Bosch; Valvanis-Vail; Furno; Spanikova; Fair; Assali], the labour income [Olexa, Holuska, Orsagova, Klein and Sasinek; Fidrmuc and Pichelman; Dombrecht; Brunia; Valvanis-Vail], and employment [Cukierman, Pazner, and Razin]. This approach is adequate in a consolidated market economy, in which the capital formation decisions usually take into account the degree of utilisation of existing capacities and the production cost. Such factors would be less conclusive in an economy like Romania's. In transition, the stock of capital is subjected to deep restructuring processes. Consequently, we did not retain it as an explanatory variable for investments.

More adequate under these conditions are indicators that reflect the financial potential of the given economy. Many models employ, in the determination of investments, gross national or domestic product, national net product, global output or aggregate demand, disposable income, wealth of the private sector, profits, private savings, and money stock [Greene; Olexa, Holuska, Orsagova, Klein and Sasinek; Fidrmuc and Pichelman; Pindyck and Rubinfeld; Scheneider, Hofreither, and Neck; Fidrmuc and Pichelmann; Dombrecht; Barten and Dhaene; Salvas-Bronsard, Lacroix, Belanger, Levesque, Montmarquette and Outlas; Fontaine, Garbley and Gilli; Lahti; Rossier; Brunia; Paleologos; Petrochilos; Chou and Lin; Fanning and Bradley; Cukierman, Pazner, and Razin; Hughes-Hallett and Petit; Petit; Gandolfo and Padoan; Galli, Terlizzese, and Visco; Naohiro, Akira, Makoto and Mitsuo; Kawasaki; Pyo; Chung; van Miltenburg (1997a, b); Ros Bosch; Valvanis-Vail; Furno; de Bondt, van Els, and Stokman; Spanikova; Tarp and Brixen; Ekstedt and Westberg; Assarson; Mattei; Thomas; Christ; Fair; Campbell; Kinoshita; Krishnamurty, Pandit, and Sharma; Assali; Gaburro (1985, 1986); Neck and Matulka; Neck and Karbuz; Jahnke et al.; Nemenyi; Serry]. For statistical reasons, we use the disposable income defined previously.

The interest rate is also often employed in the determination of investments [Greene; Olexa, Holuska, Orsagova, Klein and Sasinek; Fidrmuc and Pichelman; Pindyck and Rubinfeld; Neck and Matulka; Neck and Karbuz; Fidrmuc and Pichelmann; Salvas-Bronsard, Lacroix, Belanger, Levesque, Montmarquette and Outlas; Fontaine, Garbley and Gilli; Serry; Lahti; Brunia; Paleologos; Petrochilos; Cukierman, Pazner, and Razin; Jahnke et al.; Kawasaki; van Miltenburg (1997a, b); Valvanis-Vail; Furno; de Bondt, van Els, and Stokman; Spanikova; Ekstedt and Westberg; Assarson; Mattei; Thomas; Fair; Campbell; Adams and Dixon; Assali; Gaburro (1985, 1986)]. Similarly to private consumption, the variation of the reference interest rate of NBR (vIR) is included in the estimation of gross fixed capital formation.

Some modelling works include in the econometric specifications lagged investment [Paleologos; Petrochilos; Chou and Lin; Jahnke et al.; Furno; Campbell; Gaburro (1985, 1986)], public investment [Serry; Krishnamurty, Pandit, and Sharma; Assali], orders [Rossier]. In our opinion, such variables are not significant in the case of the Romanian economy. Instead, the inflow of foreign capital cannot be ignored. As a result, the gross fixed capital formation has been studied in correlation with the index of foreign direct and portfolio investment, too.

6. The export refers to all the transactions - either with goods or with services.

6.1. Exports are explained first of all by the foreign demand (regional or world) as economic growth or dynamics of international changes [Dombrecht; Serry; van Miltenburg (1997a, b); Lahti; Artus, Avouyi-Dovi, and Laffargue; Brunia; Chou and Lin; Cukierman, Pazner, and Razin; Faini and Rossi; Kawasaki; Eu and Semudram; Ros Bosch; Hasselman, Post, and van der Beld; de Bondt, van Els, and Stokman; Grimes,

Spencer, Dunggan, and Dick; Spanikova; Ekstedt and Westberg; Palmer and Palme; Limskul and Kalayaneer]. With this aim, we shall use the world trade in real terms.

6.2. Some modelling works make use of specific factors as utilisation rate of productive capacity [van Miltenburg (1997a, b); Lahti; Faini and Rossi; Ros Bosch; Hasselman, Post, and van der Beld; Ekstedt and Westberg], lagged export [Dombrecht; van Miltenburg (1997a, b); Lahti; Brunia; Chou and Lin; Eu and Semudram] or lagged import [Limskul and Kalayaneer]. The last of them seems to be adequate for our macromodel, too. This dependence comes from the fact that the Romanian export industries are based, in a substantial measure, on imported raw materials and energy resources.

6.3. An important export determinant is the international competitiveness. Different indicators have been used, for example, level of foreign prices, exchange rate in relation with domestic inflation etc [Dombrecht; Hall and Taylor; Abel and Bernanke; Krugman and Obstfeld; van Miltenburg (1997a, b); Lahti; Artus, Avouyi-Dovi, and Laffargue; Brunia; Chou and Lin; Fanning and Bradley; Cukierman, Pazner, and Razin; Faini and Rossi; Kawasaki; Eu and Semudram; Ros Bosch; Hasselman, Post, and van der Beld; de Bondt, van Els, and Stokman; Grimes, Spencer, Dunggan, and Dick; Spanikova; Ekstedt and Westberg; Palmer and Palme; Liang]. In our case, the competitiveness index (ICOsdr) will be defined as follows:

$$\text{ICOsdr} = \text{IERE} * \text{WTDsdr} / \text{PGDP} \quad (\text{I.B.6.1})$$

$$\text{IERE} = \text{ERE} / \text{ERE}(-1) \quad (\text{I.B.6.2})$$

where:

ERE – exchange rate, RON per Euro,

WTDsdr – world trade deflator, special drawing rights, and

PGDP – gross domestic product deflator.

Taking into account the structure of Romanian commercial changes, the world trade deflator of special drawing rights has been considered more adequate than other deflators. The influence of international competitiveness on export increases step-by-step, due to the gradual transition from command to market economy.

7. The import is also considered in a more general meaning (goods and services together).

7.1. The majority of modellers estimate import by variables linked (directly or implicitly) to the output or internal absorption. Thus, frequently gross domestic product, gross national product or total sales are utilised [Lord; Scheneider, Hofreither, and Neck; Fidrmuc and Pichelmann; Dombrecht; van Miltenburg (1997a, b); Lahti; Rossier; Brunia; Paleologos; Chou and Lin; Fanning and Bradley; Cukierman, Pazner, and Razin; Petit; Kawasaki; Moosa], as well as different indicators of income [van Miltenburg (1997a, b); Ros Bosch; Neu; de Bondt, van Els, and Stokman; Grimes, Spencer, Dunggan, and Dick; Spanikova; Tarp and Brixen; Kinoshita; Limskul and Kalayaneer; Karbuz; Fair; Elhuni; Dittus and O'Brien; Campbell; Adams and Dixon; Harper and Lim; Fukuchi, Imagawa, Oguchi, Ohno, Takenaka, and Tokunaga; Gaburro (1985, 1986)], domestic demand [Neck and Matulka; Neck and Karbuz; Barten and Dhaene; Artus, Avouyi-Dovi, and Laffargue; Jahnke et al.; Ekstedt and Westberg; Palmer and Palme], total investment expenditure [Dittus and O'Brien; Gaburro (1985, 1986)], financial wealth of the private sector [Dombrecht], liquidity ratio [van Miltenburg (1997a, b); Spanikova] or money supply [Gaburro (1985, 1986)].

The dependence of import on domestic absorption is present in the Romanian economy. But its main components – the final consumption (private and public) and the gross fixed capital formation – do not have identical influences and, consequently, are included separately.

7.2. The econometric specifications of import include also domestic and external relative prices, exchange rate, and other indicators reflecting the international competitiveness [Lord; Scheneider, Hofreither, and Neck; Neck and Matulka; Neck and Karbuz; Fidrmuc and Pichelmann; Dombrecht; van Miltenburg (1997a, b); Lahti; Artus, Avouyi-Dovi, and Laffargue; Brunia; Paleologos; Chou and Lin; Cukierman, Pazner, and Razin; Petit; Jahnke et al.; Kawasaki; Ros Bosch; Neu; de Bondt, van Els, and Stokman; Grimes and Spencer, Dunggan and Dick; Tarp and Brixen; Ekstedt and Westberg; Palmer and Palme; Kinoshita; Limskul and Kalayaneer; Karbuz; Fair; Dittus and O'Brien; Campbell; Harper and Lim; Fukuchi, Imagawa, Oguchi, Ohno, Takenaka, and Tokunaga; Kinoshita; Gaburro (1985, 1986)].

Such an influence can be found in the Romanian economy, too. Similarly to export, the effect of competitiveness on import becomes more and more significant.

7.3. The modelling literature implies other factors as capacity utilization rate [Lahti; Rossier; Ros Bosch; de Bondt, van Els, and Stokman; Spanikova], tariffs [Grimes, Spencer, Dunggan, and Dick; Karbuz], export [Artus, Avouyi-Dovi, and Laffargue; Jahnke et al.; Moosa; Ekstedt and Westberg; Karbuz, Campbell], lagged import [Scheneider, Hofreither, and Neck; Neck and Matulka; Neck and Karbuz; Fidrmuc and Pichelmann; Brunia; Chou and Lin; Kinoshita; Limskul and Kalayaneer; Fair; Dittus and Brien; Campbell; Kinoshita; Gaburro (1985, 1986)], population [Fair], interest rate [Fair], net stock of foreign security and reserve holdings [Fair; Fukuchi, Imagawa, Oguchi, Ohno, Takenaka, and Tokunaga].

We did not find such factors relevant for the Romanian economy.



8. The most frequent explanatory variables of prices are considered:

- labour cost and mark-up assumption [Dornbusch, Fischer, and Sparks; Carlin and Soskice; van Miltenburg (1997a, b); Lahti; Scheneider, Hofreither, and Neck; Rossier; Brunia; Paleologos; Gandolfo and Padoan; Kawasaki; Cordina; Ros Bosch; Hasselman, Post, and van der Beld; de Bondt, van Els, and Stokman; Spanikova; Weyerstrass; Ekstedt and Westberg; Palmer and Palme; Assarson; Karbuz; Bergstrom, Nowman, and Wandasiewicz; Fair; Adams and Dixon; McDonald and Dixon; Harper and Lim; Anderson; Krishnamurty, Pandit, and Sharma; Gaburro (1985, 1986); Fidrmuc and Pichelman],
- international prices and exchange rate [Neck and Karbuz; Wang; Serry; van Miltenburg (1997a, b); Lahti; Rossier; Artus and Bismut; Brunia; Paleologos; Chou and Lin; Gandolfo and Padoan; Aghevli and Rodriguez; Kawasaki; Moosa; Cordina; Ros Bosch; de Bondt, van Els, and Stokman; Spanikova; Palmer and Palme; Assarson; Kinoshita; Karbuz; Fair; Shams; Malcolm, Kerrison, and Menzies; Campbell; Adams and Dixon; McDonald and Dixon; Anderson; Krishnamurty, Pandit, and Sharma; Basu; Gaburro (1985, 1986); Fidrmuc and Pichelman],
- monetary variables [Wang; Serry; Paleologos; Gandolfo and Padoan; Aghevli and Rodriguez; Ito; Moosa; Eu and Semudram; Hasselman, Post, and van der Beld; Spanikova; Shams; Arnaudo; Harper and Lim; Anderson; Arif and Rangarjan; Krishnamurty, Pandit, and Sharma; Gaburro (1985, 1986)],
- taxes and budget policies [Brunia; Papadopoulos; Naohiro, Akira, Makoto, and Mitsuo; Kawasaki; Hasselman, Post, and van der Beld; Palmer and Palme; Assarson; Bergstrom, Nowman, and Wandasiewicz; Malcolm, Kerrison, and Menzies; Adams and Dixon; McDonald and Dixon; Anderson; Gaburro (1985, 1986); Fidrmuc and Pichelman],
- income or domestic absorption [Naohiro, Akira, Makoto, and Mitsuo; Campbell; Arif and Rangarjan; Basu].

The literature centred on demand pressure and output-gap is really huge. We consider the gross domestic product deflator (PGDP) as a leading price index. It is derived as the ratio between indices of nominal (IGDP) and real (IGDPc) gross domestic product. The derivation of other sectorial price indices from GDP-GNP deflator is not novel [Cukierman, Pazner, and Razin; Harper and Lim]. We also have preferred this solution taking into consideration that IGDP and IGDPc result from the entire system of behavioural and accounting relationships included in macromodel. In such determination, the gross domestic product deflator seems to be the most representative expression of the supply-demand interaction.

The consumer price index (CPI) and the price index of tangible fixed assets (PK) are, therefore, estimated in two phases: first as econometric equations and, subsequently, as components of the GDP deflator, with which they must be compatible.

8.1. The consumer price index is connected to the broad money (as main monetary variable) and the exchange rate (which incorporates the influence of international markets).

It is interesting to note that the dependence of CPI on broad money was weakened by the monetary distortion, which was significant for the Romanian transition economy (Dobrescu 2000), being present either in money supply, or in demand.

### Box: Monetary Distortion

Thus, the money supply was affected by the so-called disturbing form of "dollarization". The term disturbing "dollarization" has here a different meaning than the usual interpretation, which consists in the share (in broad money) of the foreign currency deposits of residents, evaluated using the Central Bank exchange rate. The disturbing form of "dollarization" refers to:

- a) utilisation (explicit or implicit) of the foreign currency deposits in domestic transactions at exchange rates higher than that of the Central Bank, and
- b) undertaking domestic transactions using foreign currency that exists (at households and some firms) outside the banking system.

In broad money equivalent, the disturbing form of "dollarization" (Z), can be defined by:

$$Z = (H1 * (ER^* - ER) + H2 * ER^*) * h \quad (I.B.8.1)$$

where:

H1 - foreign currency deposits of residents in the banking system, in reference foreign currency,

ER\* - actually used (explicitly or implicitly) exchange rate for domestic transactions,

ER - exchange rate of the Central Bank, by which the foreign currency deposits of residents are evaluated within M2 (it assumes that  $ER^* > ER$ ),

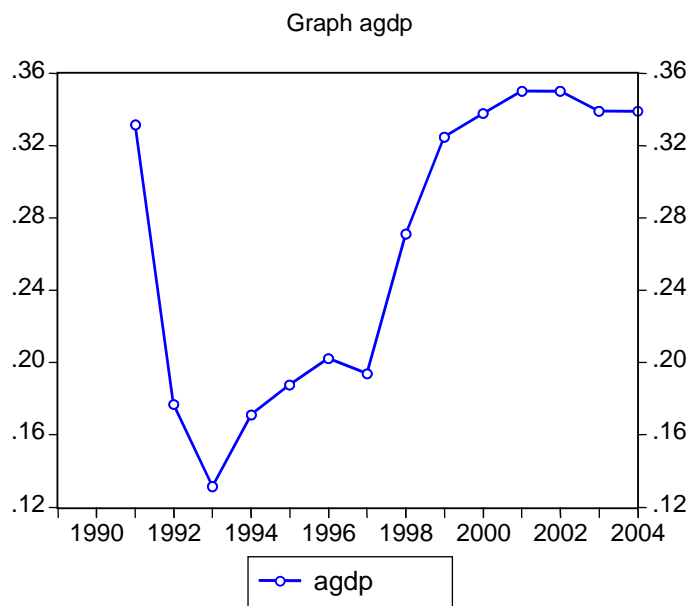
H2 - amount of foreign currency held by firms and households outside the banking system and used for carrying out domestic transactions, in reference foreign currency,

h - scaling coefficient by which the disturbing form of "dollarization" is equalized to broad money.

Therefore, the money supply can be approximated by the sum

$$Ms = M2 + Z \quad (I.B.8.2)$$

On the other hand, the money demand (Md) has also some peculiarities. Its standard dependencies on real gross domestic product (+), prices' level (+), and interest rate (-) are of course valid, but two other disturbances have interfered. The first regards the non-accounted economy, which obviously increases the money demand. The second refers to the barter operations and, especially, to the arrears (in the largest sense). The evolution of the ratio of arrears to gross domestic product (agdp) is presented in Graph agdp.



The break in 1992-1993 was determined by the global compensation of inter-enterprise arrears operated at the end of 1991.

The volume of arrears (A) can be also transformed in broad money (N); which represents the required extra amount of M2 (therefore a monetary injection), which should be pumped into economy in order to eliminate instantly the arrears and the barter operations. Consequently,

$$N = A * m \quad (I.B.8.3)$$

where m is a scaling coefficient.

The interpretation of N seems to be ambiguous. It can be considered as a money substitute, in which case it expands the money supply. But N can also be considered on the money demand side, as a diminishing factor. However, the implications on macroeconomic equilibrium are similar.

Summarising, the monetary distortion – represented by Z and N in previous Box – weakens the dependence of prices on broad money (controlled by Central Bank). This connection, nevertheless, cannot be annulled. In the case of the Romanian economy, it becomes more and more perceptible. Due to these considerations, the money supply has been maintained as an explanatory variable of the consumer price index.

8.2. A similar approach was adopted for the price index of tangible fixed assets. The broad money and the exchange rate are considered also as the most important explanatory variables of this index.

8.3. As we already mentioned, it is necessary to introduce an explicit connection of the consumer price index and the price index of tangible fixed assets to the gross domestic product deflator. This is why we introduced a corrective coefficient PRC, resulted from the assumed condition:

$$PGDP = shch \cdot CPI + shgfcf \cdot PK \quad (I.B.8.4)$$

where:

$$shch = CH / (CH + GFCF) \text{ and} \quad (I.B.8.5)$$

$$shgfcf = GFCF / (CH + GFCF) \quad (I.B.8.6)$$

CH – final consumption of households, current prices, billion RON,

GFCF - gross fixed capital formation, current prices, billion RON.

Therefore  $shch + shgfcf = 1$ .

9. Generally, the exchange rate is modelled by involving as causal variables the monetary indicators [Dornbush; Mishkin; Wang; Fair; Adams and Dixon; Krugman and Obstfeld; de Bondt, van Els, and Stokman; Weyerstrass; Matthews], its previous levels [Wang; Jahnke et al.], the domestic inflation, and the foreign capital inflows [Bergstrom, Nowman, and Wandasiewicz; Anderson; Assali; Neu; Abel and Bernanke].

In the case of Romanian economy - beside the actual sluggishness - two factors are also important: the domestic inflation and the foreign capital inflows (NCINXE). The last is interpreted as follows:

$$NCINXE = NCINE + XGSE \quad (I.B.9.1)$$

$$NCINE = NOCAE + FDPIE \quad (I.B.9.2)$$

where:

XGSE – export of goods and services, billion Euro,

NOCAE – net incomes and current transfers, billion Euro,

FDPIE – foreign direct and portfolio investment, billion Euro.

The dependence of the exchange rate on its previous level is relatively high. This is probably the consequence of a specific transition circumstance, that is the strong expectation of households and firms for depreciation of local currency. The current inflation plays also an important role. At the same time, there is an increasing influence of the international financial markets.

10. The transition processes have progressively enforced the functional role of the monetary variables. Among them, the interest rate holds a particular place. Unfortunately, we did not have reliable data concerning the commercial banking system, which developed slower and hesitatingly in Romania. Experience from our previous studies indicates the series of the National Bank's reference interest rate as the most reliable information.

10.1. Usually, the interest rate is correlated with inflation [Abel and Bernanke; Mishkin; Scheneider, Hofreither, and Neck; Neck and Karbuz; Ros Bosch; Anderson and Carlson; de Bondt, van Els, and Stokman; Bergstrom, Nowman, and Wandasiewicz; Christ; Green et al.; Fair; Arnaudo; Gaburro (1985, 1986); Pindyck and Rubinfeld] and the real output [Scheneider, Hofreither, and Neck; Neck and Karbuz; de Bondt, van Els, and Stokman; Weyerstrass; Bergstrom, Nowman, and Wandasiewicz; Green et al.; Fair; Arnaudo; Pindyck and Rubinfeld].

Our macromodel also includes these factors, but not separately. Their cumulative expression – nominal gross domestic product - proved more suitable.

10.2. The money supply is often included in the estimation of interest rate [Scheneider, Hofreither, and Neck; Neck and Matulka; Neck and Karbuz; Serry; Gandolfo and Padoan; Anderson and Carlson; Weyerstrass; Bergstrom, Nowman, and Wandasiewicz; Green et al.; Fair; Arnaudo; Campbell; Gaburro (1985, 1986); Pindyck and Rubinfeld]. The connection of the interest rate to money supply can be also observed in the Romanian economy.

10.3. There are specifications that explain the domestic interest rate, at least partially, through the foreign interest rate [Krugman and Obstfeld; Artus and Bismut; Gandolfo and Padoan; Ros Bosch; de Bondt, van Els, and Stokman; Bergstrom, Nowman, and Wandasiewicz; Malcolm, Kerrison, and Menzies] and the exchange rate [Krugman and Obstfeld; Artus and Bismut; Ros Bosch; Malcolm, Kerrison, and Menzies].

The international markets begun to play a more and more important role in the functioning of Romanian economy, too. The short-term interest rate in advanced economies (STIRAE) has been considered relevant for such analysis, taking into account the geographical structure of Romanian foreign trade and financial flows.

10.4. Sometimes, the domestic interest rate is defined in relation to other determinants as, for example, the rate of capital gain [Mishkin; Fontaine, Garbley and Gilli; Bergstrom, Nowman, and Wandasiewicz], public sector debt [de Bondt, van Els, and Stokman] etc.

The lack of information and the disturbing effects of transitional transformations did not allow, at least until now, to identify in the Romanian economy such interdependencies.

11. The integration of the above described behavioural relationships with an input-output block raises difficult problems, which results in principle from the impossibility to generate consistent sectorial supply-demand equations. In the macromodel, either the production function or the main components of domestic absorption and foreign trade are estimated as aggregate indicators at the level of the national economy.

Synthetically, the finally adopted solution is the following system:

$$GDP=GVA+NIT \quad (I.B.11.1)$$

GDP - gross domestic product, current prices, billion RON,

GVA - gross value added, current prices, billion RON,

NIT – net indirect taxes, billion RON.

$$NIT=VATO+CD-SUBP \quad (I.B.11.2)$$

VATO - value added tax, excises duties and other similar indirect taxes, billion RON,

CD - custom duties, billion RON,

SUBP - budget subsidies on goods, billion RON.

VATO, CD, and SUBP are estimated using exogenous coefficients, based on fiscal policies;

$$UF=GDP+M \quad (I.B.11.3)$$

UF – final resources, current prices, billion RON,

M - import of goods and services, billion RON.

$$M=MGSE*ERE \quad (I.B.11.4)$$

MGSE - import of goods and services, billion Euro; econometric estimation,

ERE – exchange rate, RON per Euro; econometric estimation.

$$GVA=\sum GVA_i \quad (I.B.11.5)$$

$GVA_i$  - gross value added in sector  $i$ , current prices, billion RON;  $i=1, 2, \dots, 6$ .

$$GVA_i=Q_i*(1-(a_{1i}+a_{2i}+a_{3i}+a_{4i}+a_{5i}+a_{6i})) \quad (I.B.11.6-11)$$

$Q_i$  - output in sector  $i$ , current prices, billion RON;  $i=1, 2, \dots, 6$ ,

$a_{ij}$  – input coefficients,  $i,j=1, 2, \dots, 6$ ; econometric estimations.

The input coefficients are expressed in current prices, reflecting, therefore, not only technological changes, but also modifications in relative prices.

$$Q_i=DR_i-(shm_i*M+shnit_i*NIT) \quad (I.B.11.12-17)$$

$DR_i$  – total resources of the sector  $i$ , current prices, billion RON;  $i=1,2,\dots,6$ ,

$shm_i$  – share of the sector  $i$  in import,  $i=1,2,\dots,6$ ; econometric estimations,

$shnit_i$  – share of the sector  $i$  in the net indirect taxes,  $i=1,2,\dots,6$ ; exogenous coefficients, based on fiscal policies.

$$DR_i=UF_i+a_{i1}*Q_1+a_{i2}*Q_2+a_{i3}*Q_3+a_{i4}*Q_4+a_{i5}*Q_5+a_{i6}*Q_6 \quad (I.B.11.18-23)$$

$UF_i$  - final resources of the sector  $i$ , current prices, billion RON;  $i=1,2,\dots,6$ .

$$UF_i=shu_i*UF \quad (I.B.11.24-29)$$

$shu_i$  – share of the sector  $i$  in final resources,  $i=1,2,\dots,6$ ; econometric estimations.

$$DAD=UF-X \quad (I.B.11.30)$$

DAD - domestic absorption, current prices, billion RON; econometric estimations,  
X – export of goods and services, billion RON.

$$X=XGSE*ERE \quad (I.B.11.31)$$

XGSE - export of goods and services, billion Euro; econometric estimation.

The behavioural relationships of the version 2005 of the Romanian macromodel are detailed in the second chapter.

## Chapter II Econometric Analysis

Many specifications have been tried for the building of the present macromodel. Finally, the selected relationships satisfy the conditions: a) correspond to the standard macroeconomic theorems (as much as possible); b) correctly describe the peculiarities of the Romanian market economy; c) generate plausible results in simulations.

The statistical series are relatively short and often fractured, due to the deep transforming processes of transition. As it is known, ADF test of stationarity does not offer conclusive results in the case of limited number of observations; as a rule, the series satisfying it were nevertheless used. The Granger causality test was computed for one, two, and three lags. The simplest methods of estimation were also preferred. The structural breaks in the evolution of some indicators have been handled by the inclusion of dummies. Obviously, all these circumstances weaken the stability of econometric coefficients that must be continuously updated.

The main relationships are grouped in seven sections:

- input-output block;
- labour market,
- production function;
- domestic absorption,
- foreign trade,
- prices and exchange rate, and
- interest rate.

Econometric-Views has been used.

### A. Input-Output Block

This block operates with two types of coefficients:

- input coefficients ( $a_{ij}$ ) implied in determination of output, and
- those defining the final utilization of resources (more precisely its sectorial distribution).

1. For the adopted classification of economic activities (six sectors), 36 input coefficients have been computed.

The econometric estimations of these coefficients are based on several hypotheses.

- Despite the effects induced by the transitional transformations (changes in the sectorial structure, in relative prices, technologies, etc), it is assumed that the input coefficients tend towards the long-run stable levels (likely the consolidated functional market systems).

- This tendency is conceived as an autoregressive adaptive process, the differences between actual coefficients and their long-run levels being influenced by the past deviations.

- For uniformity, the same specification is adopted for all coefficients. Such a simplification is useful for computational reasons. It starts with:

$$a_{ij} = a_{ij}^* + b(a_{ij}^* - a_{ij}(-1)) = a_{ij}^*(1+b) - b a_{ij}(-1) \quad (II.A.1.1)$$

where  $a_{ij}^*$  represent the long-run levels of  $a_{ij}$ . It is assumed that  $0 < |b| < 1$ , which means that actual  $a_{ij}$  tend asymptotically towards  $a_{ij}^*$ . Correspondingly, the first order difference operator is defined in this way:

$$\begin{aligned} \Delta a_{ij} &= a_{ij} - a_{ij}(-1) = a_{ij}^*(1+b) - b a_{ij}(-1) - a_{ij}(-1) = \\ &= a_{ij}^*(1+b) - (1+b) a_{ij}(-1) = g - h a_{ij}(-1) \end{aligned} \quad (II.A.1.2)$$

where  $g = a_{ij}^*(1+b)$  and  $h = (1+b)$ ; therefore,  $a_{ij}^* = g/h$ .

Because of the shortness of statistical series (1989-2001), the probabilities and critical values of Augmented Dickey-Fuller test may not be accurate enough. This test has been nevertheless applied, with one lag. In more than two thirds of cases, the series  $a_{ij}$  are  $I(0)$  (generally with >90% and only in several situations

with >80% confidence interval); the rest of them are I(1). We stress once more that the specification  $\Delta a_{ij}=g-h*a_{ij}(-1)$  was computed for all input coefficients. Sometimes, dummy variables are also introduced.

The main results are presented in Table no. IIA1 (parameters c(1)-c(72) in macromodel).

Table no. IIA1  
The estimates of g and h for the basic sample

$\Delta a_{ij}$	g	h	$g/h=a_{ij}^*$
$\Delta a_{11}$	c(1)=0.094461	c(2)=0.355968	0.265364
$\Delta a_{12}$	c(3)=0.00025	c(4)=0.85982	0.000291
$\Delta a_{13}$	c(5)=-0.03503	c(6)=-0.29589	0.118372
$\Delta a_{14}$	c(7)=0.000112	c(8)=0.268758	0.000417
$\Delta a_{15}$	c(9)=0.000247	c(10)=0.612018	0.000404
$\Delta a_{16}$	c(11)=0.003917	c(12)=0.67454	0.005807
$\Delta a_{21}$	c(13)=0.016678	c(14)=0.456711	0.036518
$\Delta a_{22}$	c(15)=0.283832	c(16)=0.542319	0.523367
$\Delta a_{23}$	c(17)=0.05151	c(18)=0.537789	0.095781
$\Delta a_{24}$	c(19)=0.037157	c(20)=0.404205	0.091926
$\Delta a_{25}$	c(21)=0.050273	c(22)=0.372511	0.134957
$\Delta a_{26}$	c(23)=0.043055	c(24)=0.783821	0.05493
$\Delta a_{31}$	c(25)=0.051004	c(26)=0.433984	0.117525
$\Delta a_{32}$	c(27)=0.04486	c(28)=0.535192	0.08382
$\Delta a_{33}$	c(29)=0.172608	c(30)=0.54743	0.315306
$\Delta a_{34}$	c(31)=0.09475	c(32)=0.329547	0.287516
$\Delta a_{35}$	c(33)=0.089491	c(34)=0.492403	0.181743
$\Delta a_{36}$	c(35)=0.137139	c(36)=0.445344	0.307939
$\Delta a_{41}$	c(37)=0.000966	c(38)=0.442662	0.002182
$\Delta a_{42}$	c(39)=0.004796	c(40)=0.637328	0.007525
$\Delta a_{43}$	c(41)=0.001368	c(42)=0.558931	0.002448
$\Delta a_{44}$	c(43)=0.025766	c(44)=0.48042	0.053632
$\Delta a_{45}$	c(45)=0.007348	c(46)=0.800619	0.009178
$\Delta a_{46}$	c(47)=0.007819	c(48)=0.55962	0.013972
$\Delta a_{51}$	c(49)=0.018031	c(50)=0.84147	0.021428
$\Delta a_{52}$	c(51)=0.058295	c(52)=0.906571	0.064303
$\Delta a_{53}$	c(53)=0.021308	c(54)=0.91221	0.023359
$\Delta a_{54}$	c(55)=0.027122	c(56)=0.810934	0.033445
$\Delta a_{55}$	c(57)=0.019438	c(58)=0.268597	0.072369
$\Delta a_{56}$	c(59)=0.043159	c(60)=0.777732	0.055493
$\Delta a_{61}$	c(61)=0.007149	c(62)=0.759087	0.009418
$\Delta a_{62}$	c(63)=0.003102	c(64)=0.127849	0.024263
$\Delta a_{63}$	c(65)=0.004151	c(66)=0.23324	0.017797
$\Delta a_{64}$	c(67)=0.022443	c(68)=0.268232	0.08367
$\Delta a_{65}$	c(69)=0.010774	c(70)=0.218603	0.049286
$\Delta a_{66}$	c(71)=0.067766	c(72)=0.443329	0.152857

The relationship for  $\Delta a_{13}$  is characterised by negative econometric estimates, which may generate some difficulties. Thus, if we shall compute a projection for several consecutive years, the coefficient  $a_{13}$  itself could become also negative. Consequently, for the main scenario concerning 2005-2010 years, the following specification has been adopted:

$$a_{13}=c(5a)+c(6a)*(a_{13}(-1)-c(5a))/t \quad (\text{II.A.1.3})$$

where  $c(5a)$  represents the long run level of this coefficient. The macromodel operates after 2004 year, that is for  $t > 16$ . Under these conditions, the obtained estimates ( $c(5a)=0.097031$  and  $c(6a)=3.151792$ ) allow the convergence towards positive  $a_{13}$ .

With sufficiently long statistical series, in (II.A.1.2),  $b \rightarrow 0$ ; consequently  $h \rightarrow 1$  and  $a_{ij}^* \rightarrow g$ . Such a property has been illustrated using a sui-generis Monte-Carlo experiment. Thus, statistical data for Romania (1989-2001 years) were randomly mixed to obtain series of 1001 terms; all the horizontal vectors undergone this procedure, in order not to affect the structure of sectorial changes.

Table no.IIA2  
The estimates of  $g$  and  $h$  for a random sample

$\Delta a_{ij}$	$g$	$h$	$g/h = a_{ij}^*$
$\Delta a_{11}$	0.229793	0.990763	0.231935
$\Delta a_{12}$	0.00029	1.007236	0.000288
$\Delta a_{13}$	0.10878	0.982724	0.110692
$\Delta a_{14}$	0.000497	0.998091	0.000498
$\Delta a_{15}$	0.000342	0.970387	0.000352
$\Delta a_{16}$	0.006938	0.976665	0.007104
$\Delta a_{21}$	0.044493	0.97875	0.045459
$\Delta a_{22}$	0.516636	0.972327	0.53134
$\Delta a_{23}$	0.094215	1.001973	0.094029
$\Delta a_{24}$	0.085985	1.016591	0.084582
$\Delta a_{25}$	0.128719	1.032674	0.124646
$\Delta a_{26}$	0.05213	0.958231	0.054402
$\Delta a_{31}$	0.130841	0.991762	0.131928
$\Delta a_{32}$	0.084123	0.976806	0.08612
$\Delta a_{33}$	0.333505	0.980314	0.340202
$\Delta a_{34}$	0.32524	0.966513	0.336509
$\Delta a_{35}$	0.186255	0.984842	0.189122
$\Delta a_{36}$	0.304863	0.954527	0.319386
$\Delta a_{41}$	0.003925	0.989318	0.003967
$\Delta a_{42}$	0.009412	1.002036	0.009393
$\Delta a_{43}$	0.002396	0.967799	0.002476
$\Delta a_{44}$	0.047016	0.996604	0.047176
$\Delta a_{45}$	0.008566	0.997065	0.008591
$\Delta a_{46}$	0.01781	0.986821	0.018048
$\Delta a_{51}$	0.02103	0.95029	0.02213
$\Delta a_{52}$	0.05822	0.999922	0.058225
$\Delta a_{53}$	0.022697	0.960781	0.023623
$\Delta a_{54}$	0.036114	1.042684	0.034636
$\Delta a_{55}$	0.077224	0.975483	0.079165
$\Delta a_{56}$	0.052544	0.921843	0.056999
$\Delta a_{61}$	0.009318	1.005191	0.00927
$\Delta a_{62}$	0.017717	0.998148	0.01775
$\Delta a_{63}$	0.019085	0.986551	0.019345
$\Delta a_{64}$	0.069353	0.972389	0.071322
$\Delta a_{65}$	0.040158	0.980053	0.040975
$\Delta a_{66}$	0.142847	1.003853	0.142299

As expected, the levels of  $a_{ij}^*$  are similar in both applications.

The macromodel uses the estimates of  $g$  and  $h$  deduced from basic sample.

2. The sectorial structure of imports is defined using the parameters  $shm_i$  from input-output tables. The estimation procedure is the one used in the case of input coefficients. However, the series  $shm_2$  and  $shm_3$  are characterised by significant volatility, which makes less adequate such an approach. That is why, the procedure will be applied on sum  $shm_{23}$  ( $=shm_2+shm_3$ ).

The results of regressions will be presented, as before, for the basic sample and for the random one; in the last case, the horizontal vectors have been mixed.

Table no. IIA3  
The estimates of  $g$  and  $h$  for basic sample

	$g$	$h$	$g/h$	$shm_i^* = g/(h*0.993825)$
$\Delta shm_1$	$c(73)=0.015073$	$c(74)=0.636407$	0.023685	0.023832
$\Delta shm_{23}$	$c(75)=0.437494$	$c(76)=0.492019$	0.889179	0.894704
$\Delta shm_4$	$c(77)=0.000778$	$c(78)=0.528472$	0.001473	0.001482
$\Delta shm_5$	$c(79)=0.006043$	$c(80)=0.239541$	0.025229	0.025385
$\Delta shm_6$	$c(81)=0.013203$	$c(82)=0.243334$	0.054259	0.054596
Total			0.993825	1

Evidently, the corrective coefficient 0.993825 is imposed by the condition  $\sum shm_i=1$ .

Table no. IIA4  
The estimates of  $g$  and  $h$  for random sample

	$g$	$h$	$shm_i^* = g/h$
$\Delta shm_1$	0.028407	0.981675	0.028937
$\Delta shm_{23}$	0.826276	0.931194	0.887329
$\Delta shm_4$	0.001557	0.982803	0.001585
$\Delta shm_5$	0.026152	1.003523	0.02606
$\Delta shm_6$	0.054382	0.969579	0.056089
Total			1

Again the values of  $shm_i^*$  in both applications are similar. The estimates obtained from the basic sample will be included in the macromodel.

The components of  $\Delta shm_{23}$  are estimated by the additional relationship:

$$\Delta shm_2 = c(83) * \Delta shm_3 \quad (II.A.2.1)$$

where  $c(83)=-0.712152$ . Therefore:

$$\Delta shm_2 = -0.712152 * \Delta shm_3 \quad (II.A.2.2) \text{ and}$$

$$\Delta shm_{23} = \Delta shm_2 + \Delta shm_3 = 0.437494 - 0.492019 * shm_{23}(-1) \quad (II.A.2.3)$$

In order to avoid any possible confusion with the actual statistical data, the prefix  $f$  will be adopted for fitted values, that is:

$$f\Delta shm_2 = -0.712152 * f\Delta shm_3 \quad (II.A.2.4)$$

$$f\Delta shm_{23} = f\Delta shm_2 + f\Delta shm_3 = 0.437494 - 0.492019 * shm_{23}(-1) \quad (II.A.2.5)$$

yielding



$$f\Delta shm_3 = (0.437494 - 0.492019 * shm_{23}(-1)) / (1 - 0.712152) \quad (II.A.2.6) \text{ and}$$

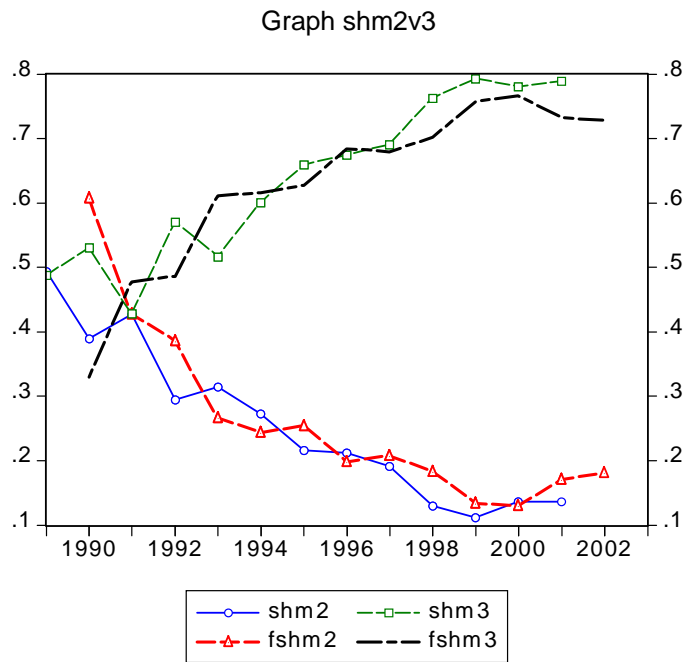
$$f\Delta shm_2 = f\Delta shm_{23} - f\Delta shm_3 \quad (II.A.2.7)$$

Consequently, the fitted series of  $shm_2$  and  $shm_3$  are:

$$fshm_2 = shm_2(-1) + f\Delta shm_2 \quad (II.A.2.8) \text{ and}$$

$$fshm_3 = shm_3(-1) + f\Delta shm_3 \quad (II.A.2.9)$$

The fitted and original series are presented in Graph shm2v3.



The results seem acceptable.

3. The sectorial structure of the final utilisation of resources will be estimated on the basis of the corresponding shares computed from the input-output tables. The estimation procedure presented for the coefficients  $a_{ij}$  will be again applied in this case. In order to observe the restriction  $\sum shu_i = 1$ , a corrective parameter is also introduced.

Table no. IIA5  
The estimates of g and h for basic sample

	g	h	g/h	$shu_i^* = g / (h * 1.021525)$
$\Delta shu1$	$c(84)=0.068609$	$c(85)=0.558733$	0.122794	0.120206
$\Delta shu2$	$c(86)=0.050328$	$c(87)=0.936383$	0.053748	0.052615
$\Delta shu3$	$c(88)=0.281478$	$c(89)=0.609256$	0.462003	0.452268
$\Delta shu4$	$c(90)=0.051132$	$c(91)=0.625516$	0.081744	0.080021
$\Delta shu5$	$c(92)=0.01873$	$c(93)=0.325093$	0.057615	0.056401
$\Delta shu6$	$c(94)=0.040338$	$c(95)=0.165576$	0.243622	0.238488
Total			1.021525	1

These estimates will be used in the model.

Table no. IIA6  
The estimates of g and h for random sample

	g	h	shu <sub>i</sub> =g/h
Δshu1	0.112466	0.95893	0.117283
Δshu2	0.052262	0.978122	0.053431
Δshu3	0.443277	0.94627	0.468447
Δshu4	0.087813	1.007091	0.087195
Δshu5	0.052577	0.99171	0.053016
Δshu6	0.22695	1.028654	0.220629
Total			1.000001

The structure of the final utilisation of resources is characterised, therefore, by the preponderance of the secondary sector (3+4) with 55.56%; the shares of primary (1+2) and tertiary (5+6) sectors represent 17.07% and, respectively, 27.37%. Obviously, these estimates of shu<sub>i</sub> reflect the peculiarities of the Romanian economy in the 90-th years.

## B. Labour Market

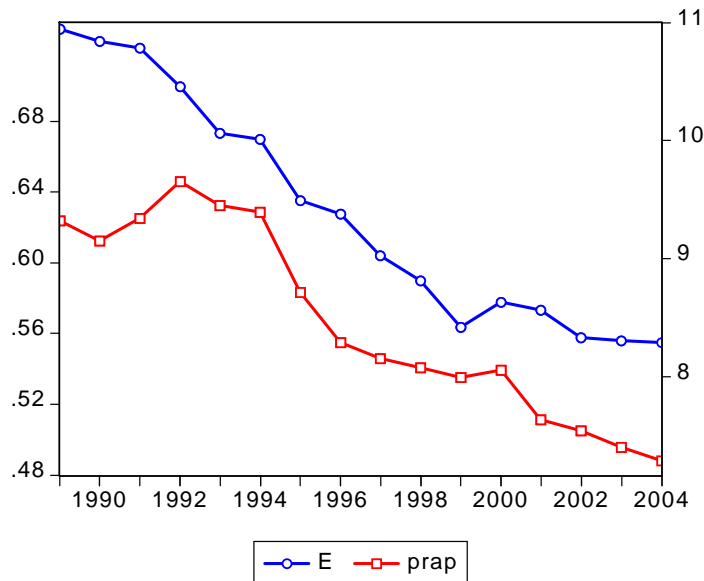
Three major relationships (decisive for the functioning of the labour market mechanisms) will be analysed:

- labour force participation rate,
- unemployment rate, and
- the rate of labour income per employed person.

1. The labour force participation rate is determined as a ratio of labour force to population over 15 years.

1.1. The dependence of this rate (prap) on employment is clearly illustrated by the Graph E-prap, in which E represents the employment (million persons).

Graph E-prap



The correlation coefficient is 0.9337. The Granger causality test also suggests a possible dependence of the labour force participation rate on the previous evolution of employment.

1.2. The adopted specification retains the first lag for prap and the second one for E, which reflect the relatively high inertia of the labour market processes. Therefore:

$$\text{prap} = c(96) * \text{prap}(-1) + c(97) * E(-2) \quad (\text{II.B.1.1})$$

with estimates

$$c(96) = 0.463472$$

$$c(97) = 0.031282$$

If the employment stabilises, the labour force participation rate tends to the long run level  $E(-2) * c(97) / (1 - c(96))$ . Normally, in the regression could be included, instead of prap, directly labour force (LF). The chosen specification has been preferred because of the presence (even implicit) of a demographic parameter - population over 15 years.

2. The unemployment rate (ru) is the second relationship analysed. It is defined as follows:

$$ru=(LF-E)/LF \quad (II.B.2.1)$$

where

LF – labour force, million persons, and

E – employment, million persons.

The preliminary analysis showed a significant correlation of this rate with the rate of unit labour cost (rIULC):

$$rIULC=IULC-1 \quad (II.B.2.2)$$

$$IULC=LI/(LI(-1)*IGVAc) \quad (II.B.2.3)$$

$$IGVAc=GVA/(GVA(-1)*PGDP) \quad (II.B.2.4)$$

where

LI – labour income, billion RON,

GVA – gross value added, current prices, billion RON,

PGDP – gross domestic product deflator (previous year=1).

The Granger causality test revealed a short-run interdependence between ru and rIULC.

2.1. Consequently, the following specification has been adopted:

$$ru=c(98)*ru(-1)+c(99)*rIULC \quad (II.B.2.5)$$

The signs are expected to be positive for both estimates. The results of the regression confirm this assumption:

$$c(98)=0.800636$$

$$c(99)=0.025003$$

2.2. This equation is slightly transformed by several algebraical manipulations. Thus:

$$(LF-E)/LF=c(98)*ru(-1)+c(99)*(LI/(LI(-1)*IGVAc)-1) \quad (II.B.2.6)$$

$$LF-E=LF*(c(98)*ru(-1)+c(99)*(LI/(LI(-1)*IGVAc)-1)) \quad (II.B.2.7)$$

$$-E=LF*(c(98)*ru(-1)-c(99)-1)+LF*c(99)*LIE*E/(LI(-1)*IGVAc) \quad (II.B.2.8)$$

where LIE represents labour income per employed person, thousand RON.

$$E=-LF*(c(98)*ru(-1)-c(99)-1)-LF*c(99)*LIE*E/(LI(-1)*IGVAc) \quad (II.B.2.9)$$

Substituting:

$$A1=-LF*(c(98)*ru(-1)-c(99)-1)$$

$$A2=LF*c(99)/(LI(-1)*IGVAc)$$

$$E=A1-A2*LIE*E \quad (II.B.2.10)$$

$$E=A1/(1+A2*LIE) \quad (II.B.2.10a)$$

Consequently, the above equation can be considered as a labour demand relationship. The parameters A1 and A2 have been computed for 2004 in three cases, depending on the levels of LF and IGVAc considered (statistical data for the rest of indicators).

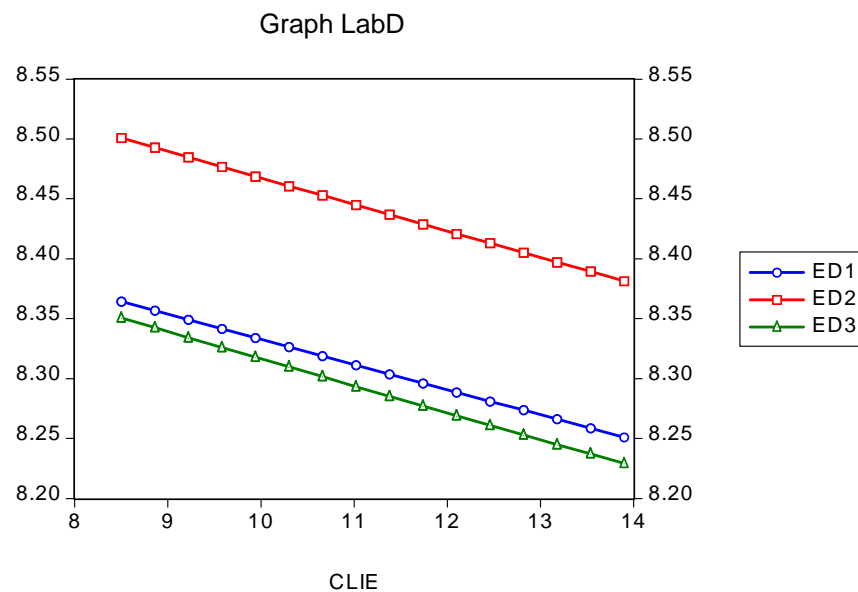
Table no. IIB1

Variants	Hypotheses	A1	A2
I	Statistical data for LF (=8.848 mill.) and IGVAc (=1.0865)	8.5493	0.0026
II	Statistical data for IGVAc and 9 mill. for LF	8.6961	0.0027
III	Statistical data for LF and 1.025 for IGVAc	8.5493	0.0028

For simulations, a common series of labour income per employed person (noted CLIE) is used; it varies from 8.5 to 13.9 thousand RON. Three series of ED are determined, thus:

ED1 corresponding to IA1 and IA2,

ED2 corresponding to IIA1 and IIA2, and  
ED3 corresponding to IIIA1 and IIIA2,  
ED1, ED2, and ED3 are plotted on Graph LabD.



The slope of employment (descending against labour income) is typical for a labour demand curve.

3. A labour income equation has been also examined, either in real terms (3a) or in nominal ones (3b).

3a. The first approach focuses attention on the difference between the index of real labour income per employed person and the index of labour productivity (dLIP):

$$dLIP = IRLIE - ILP \quad (II.B.3.1)$$

$$IRLIE = (LIE / LIE(-1)) / CPI \quad (II.B.3.2)$$

$$ILP = IGVAc / IE \quad (II.B.3.3)$$

where:

LIE – nominal labour income per employed person,

CPI – consumer price index,

IGVAc – index of gross value added at constant prices, and

IE – index of employment ( $=E/E(-1)$ ).

3a.1. Despite specific transition behaviours, the statistical series reveal that dLIP is linked to the rate of unemployment (ru).

3a.2. For the specification

$$dLIP = c(206) * ru + c(207) * ru(-1) \quad (II.B.3.4)$$

the following estimates have been obtained:

$$c(206) = -3.101990$$

$$c(207) = 2.821247$$

The negative influence of unemployment on labour income results from  $(c(206) + c(207)) < 0$ .

3a.3. The last formula will be also analysed from the labour market perspective.

$$IRLIE-ILP=c(206)*(LF-E)/LF+c(207)*ru(-1) \quad (II.B.3.5)$$

$$LIE/(LIE(-1)*CPI)-IGVAc/IE=c(206)*(LF-E)/LF+c(207)*ru(-1) \quad (II.B.3.6)$$

$$LIE/(LIE(-1)*CPI)-IGVAc*E(-1)/E=c(206)+c(207)*ru(-1)-c(206)*E/LF \quad (II.B.3.7)$$

$$\begin{aligned} & LIE-IGVAc*LIE(-1)*CPI*E(-1)/E= \\ & =LIE(-1)*CPI*(c(206)+c(207)*ru(-1))-LIE(-1)*CPI*c(206)*E/LF \quad (II.B.3.8) \end{aligned}$$

and, after the substitutions:

$$C1=IGVAc*LIE(-1)*CPI*E(-1)$$

$$C2=LIE(-1)*CPI*(c(206)+c(207)*ru(-1))$$

$$C3=LIE(-1)*CPI*c(206)/LF$$

$$LIE-C1/E=C2-C3*E \quad (II.B.3.8a)$$

$$E*LIE-C1=E*C2-C3*E^2 \quad (II.B.3.8b)$$

$$C3*E^2+(LIE-C2)*E-C1=0 \quad (II.B.3.8c)$$

Corresponding to 2004 statistical values, we have

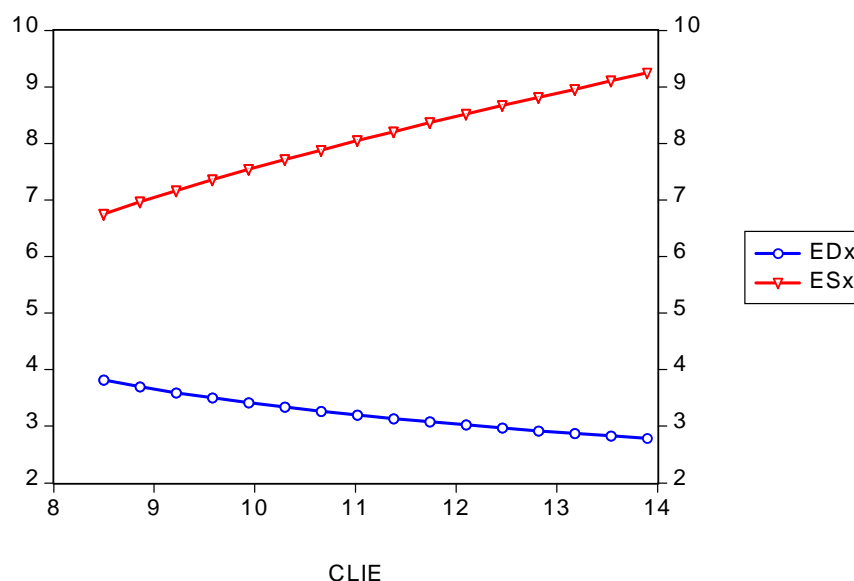
$$C1=94.936$$

$$C2=-30.454$$

$$C3=-3.6881$$

The discriminant  $((LIE-C2)^2-4*C3*(-C1))$  is positive for all values of CLIE, which means that the equation has two different real roots (series EDx and ESx). They are represented on Graph EDSx.

Graph EDSx



Therefore, the equation dLIP generates simultaneously both a labour supply and a labour demand curve. Due to this ambiguity, we did not use this formula.

3b. Another way has been, however, investigated.

3b.1. The nominal labour income per employed person, as an annual rate, is considered as the dependent variable

$$rLIE=ILIE-1 \quad (II.B.3.9)$$

$$ILIE=LIE/LIE(-1) \quad (II.B.3.10)$$

Two explicative factors have been selected.

- The variation of the unemployment rate ( $dru=ru-ru(-1)$ ) is the first of them.
- The inflation rate ( $rCPI$ ) is the other short run determinant:

$$rCPI=CPI-1 \quad (II.B.3.11)$$

where CPI is the consumer price index

3b.2. Consequently, the specification

$$rLIE=c(100)*rLIE(-1)+c(101)*dru+c(102)*rCPI \quad (II.B.3.12)$$

has been preferred, where:

$$c(100)=0.215462$$

$$c(101)=-4.182919$$

$$c(102)=0.709667$$

We must take into account that the post-factum indexation of wages has been practiced; this explains why  $c(102)$  is positive, but  $<1$ . The high modulus of  $c(101)$  is interesting; it means that – despite the appearances – the market mechanisms become more and more influent in the labour field.

3b.3. The previous exercise (points 2.3. and 3a.3.) will be repeated:

$$LIE/LIE(-1)-1=c(100)*rLIE(-1)+c(101)*((LF-E)/LF-ru(-1))+c(102)*rCPI \quad (II.B.3.13)$$

$$LIE/LIE(-1)-1=c(100)*rLIE(-1)+c(101)-c(101)*E/LF-c(101)*ru(-1)+c(102)*rCPI \quad (II.B.3.14)$$

$$E=LF*(c(100)*rLIE(-1)+c(101)-c(101)*ru(-1)+c(102)*rCPI+1)/c(101)-LIE*LF/(LIE(-1)*c(101)) \quad (II.B.3.15)$$

and substituting:

$$B1=LF*(c(100)*rLIE(-1)+c(101)-c(101)*ru(-1)+c(102)*rCPI+1)/c(101)$$

$$B2=LF/(LIE(-1)*c(101))$$

$$E=B1-LIE*B2 \quad (II.B.3.15a)$$

The parameters  $B1$  and  $B2$  were computed for 2004 also in three cases, depending on the levels of  $LF$  and  $rCPI$  (using statistical data for the rest of indicators).

Table no. IIB2

Variants	Hypotheses	B1	B2
I	Statistical data for $LF$ (=8.848 mill.) and $rCPI$ (=0.119)	5.7512	-0.225
II	Statistical data for $rCPI$ and 9 mill. for $LF$	5.85	-0.2289
III	Statistical data for $LF$ and and 0.05 for $rCPI$	5.8548	-0.225

Using again CLIE data, three series of  $E$  will be determined, thus:

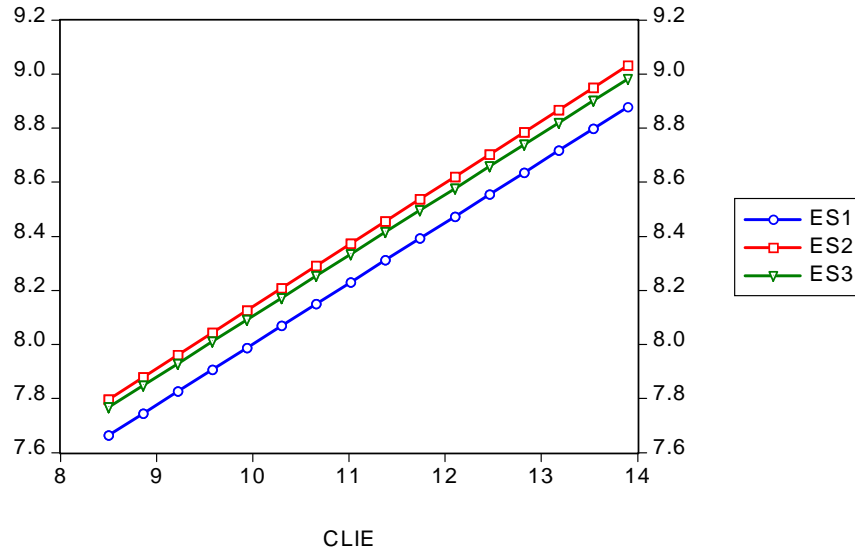
ES1 corresponding to IB1 and IB2,

ES2 corresponding to IIB1 and IIB2, and

ES3 corresponding to IIIB1 and IIIB2,

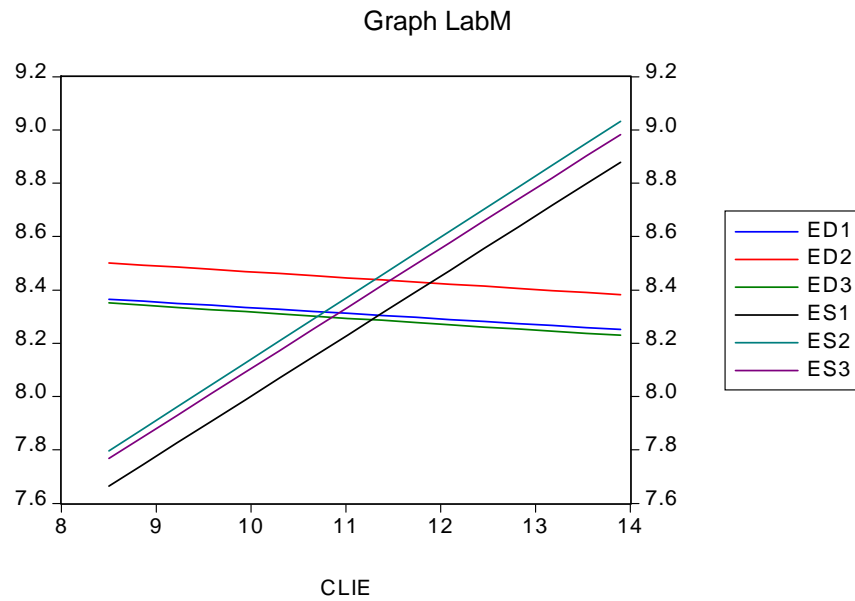
ES1, ES2, and ES3 are plotted on Graph LabS.

Graph LabS



The slope of employment (ascending against labour income) is characteristic of a labour supply curve.

4. Graph LabM combines the above presented labour demand and supply curves.



Recall that ED1 and ES1 are determined using exclusively the 2004 data. Their intersection

$$A1/(1+A2*LIE)=B1-LIE*B2 \quad (\text{II.B.4.1})$$

$$B2*A2*LIE^2-(B1*A2-B2)*LIE+(A1-B1)=0 \quad (\text{II.B.4.1a})$$

is at 11.34712. Comparatively, the statistical level (10.93625) is smaller by 3.6%.

### C. Production Function

1. The starting point is an usual production function with capital and labour, expressed in yearly indices:

$$IGDP_c = IE^\alpha \cdot ICK_c^{(1-\alpha)} \cdot ITFP \quad (II.C.1.1)$$

where:

IGDP<sub>c</sub> – index of gross domestic product at constant prices,

IE – index of employment,

alpha – elasticity of output with respect to labour,

ICK<sub>c</sub> – index of conventional tangible fixed assets at constant prices, and

ITFP – index of the total factor productivity.

Admitting that IE is determined by labour market equations, this production function involves estimation of ICK<sub>c</sub>, alpha, and ITFP.

The index of tangible fixed assets is defined as follows:

$$ICK_c = (CK_{(-1)} \cdot (1 - dfa) + GFCFc) / CK_{(-1)} = 1 - dfa + GFCFc / CK_{(-1)} \quad (II.C.1.2)$$

where

CK<sub>(-1)</sub> – conventional tangible fixed assets of previous year in current prices.

dfa – depreciation rate of the tangible fixed assets,

GFCFc – gross fixed capital formation at previous year prices, estimated by its value in current prices deflated by the corresponding price index (PK).

2. The macromodel generates estimations for so-called registered labour income (LI) and gross value added (GVA), which allows us to compute the coefficient alpha<sub>1</sub>. The production function operates, however, with parameter alpha, namely extended share of labour income in GVA.

2.1. The derived coefficients are deduced:

$$a_{1a} = \alpha_1 / \alpha, \quad (II.C.2.1) \text{ and}$$

$$da_{1a} = a_{1a} - a_{1a}^{(-1)} \quad (II.C.2.2)$$

The preliminary data analysis has showed that the first order difference of alpha<sub>1</sub> is connected, at least on medium-term, to the rate of employment (rIE):

Such a correlation could be explained through the influence of economic growth (reflected by rIE) on the ratio between „observable” and „unobservable” sectors of the national economy. Besides, the series da<sub>1a</sub> presents frequent oscillations due, probably, to the specific context of the transition processes.

2.2. For the relationship

$$da_{1a} = c(103) \cdot rIE + c(104) \cdot t \quad (II.C.2.3)$$

the estimates are:

$$c(103) = 0.912754$$

$$c(104) = -0.265078$$

The coefficient c(104) captures the mentioned oscillations of da<sub>1a</sub>. In addition, it indicates that the erratic behaviour of the da<sub>1a</sub> series is disappearing step-by-step, which may be interpreted as a temporary peculiarity of transition.

Consequently, the extended share of labour income in GVA can be estimated as follows:

$$a_{1a} = da_{1a} + a_{1a}^{(-1)} \quad (II.C.2.4)$$

$$\alpha = \alpha_1 / a_{1a} \quad (II.C.2.5)$$

3. As we have already mentioned, the total factor productivity has been determined as an index by the relationship:

$$ITFP = IGDP_c / ((IE^\alpha) \cdot (ICK_c^{(1-\alpha)})) \quad (I.C.4.1)$$

3.1. As determinants of ITFP, the following factors are included:

- the level of alpha itself;
- the intensity of the investment process;
- the demand pressure;
- the effect of institutional changes.

3.1a. Regarding alpha, we must first estimate its long-run (equilibrium) level (alpha<sub>0</sub>). The approach adopted for input-output coefficients is used here as well. Consequently, an equation for the first order difference of alpha (noted dalpha) is estimated:

$$d\alpha = c(210) - c(211) \cdot \alpha^{(-1)} \quad (II.C.3.1)$$



where:

$c(210)=0.2966117134$  and

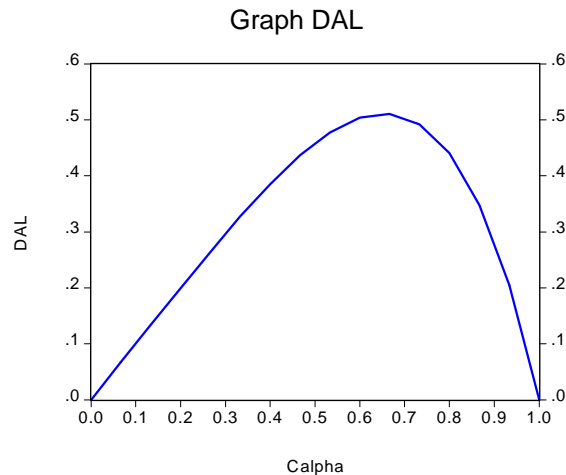
$c(211)=0.4536594299$

For  $\alpha=0$ , we obtain  $\alpha_{\text{h0}}=0.653821$ , which is close enough to the average  $\alpha$  registered in consolidated market economies. Defined as in (I.B.2.4), the parameter  $a$  is equal to 4.58235724.

The above discussed hypotheses are illustrated by the Graph DAL, which presents the value

$$\text{DAL}=\alpha-\alpha^{4.58235724} \quad (\text{II.C.3.2})$$

computed for a complete  $\alpha$  series (from 0 to 1), noted Calpha.



3.1b. The investment intensity is approximated by the rate, in real terms, of the gross fixed capital formation (rIGFCFc):

$$\text{IGFCFc}=\text{GFCF}/(\text{GFCF}(-1)*\text{PK}) \quad (\text{II.C.3.3})$$

$$\text{rIGFCFc}=\text{IGFCFc}-1 \quad (\text{II.C.3.4})$$

where

GFCF – gross fixed capital formation, current prices, bill. RON,

PK – price index of tangible fixed assets (previous year=1).

This factor has been included because of the decisive role of investment in the technological improvement of the production of goods and services. Due to the delay of this positive action, the rate, in real terms, of gross fixed capital formation is included as a geometrical moving average:

$$\text{AIGFCFc}=(\text{IGFCFc}(-1)*\text{IGFCFc})^{(1/2)} \quad (\text{II.C.3.5})$$

$$\text{rAIGFCFc}=\text{AIGFCFc}-1 \quad (\text{II.C.3.6})$$

3.1c. The stock of capital is introduced as such in the production function, independently of the degree in which it is covered by orders (as we already mentioned). As a result, it would be difficult to reject a possible link between the demand pressure and total factor productivity because of the influence of the first factor on the utilisation rate of capacities. The domestic demand pressure (DDP) is defined thus:

$$\text{IDAD}=\text{DAD}/\text{DAD}(-1) \quad (\text{II.C.3.7})$$

$$\text{IGDP}=\text{GDP}/\text{GDP}(-1) \quad (\text{II.C.3.8})$$

$$\text{DDP}=\text{IDAD}/\text{IGDP} \quad (\text{II.C.3.9})$$

$$\text{rDDP}=\text{DDP}-1 \quad (\text{II.C.3.10})$$

where:

DAD – domestic absorption, current prices, billion RON

GDP – gross domestic product, current prices, billion RON

Normally, the demand pressure does not affect immediately the utilisation rate of productive capacities; its effect becomes more visible in the next period. Consequently, the first lag of the factor will be included in specification.

3.1d. A positive correlation has been also identified between the total factor productivity and unemployment rate, which probably reflects the pressing influence of the last factor on the labour-intensity of the employed workers.

A moving arithmetical average has been adopted:

$$\text{maru}=(\text{ru}(-1)+\text{ru})/2 \quad (\text{II.C.3.11})$$

3.1e. The influence of the transitional reforms is captured by the time factor. The Hodrick-Prescott filter suggests that the initial unfavourable effects of institutional changes are resorbed quickly enough.

The constant is included to reflect the trend of total factor productivity.

3.2. The regression

$$\text{ITFP}=(\alpha-\alpha^{4.58235724})*(c(105)+c(106)*\text{rAIGFCFc}+c(107)*\text{rDDP}(-1)+c(108)*\text{maru}(-1)+c(138)/t) \quad (\text{II.C.3.12})$$

has generated the coefficients:

$$c(105)=1.975529$$

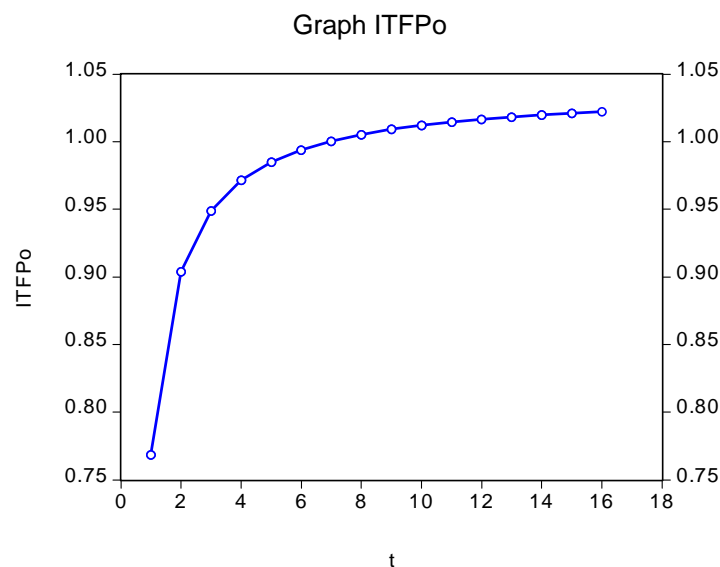
$$c(106)=0.393543$$

$$c(107)=0.533134$$

$$c(108)=1.240195$$

$$c(138)=-0.529765$$

The sign of  $c(138)$  attests the increasing positive influence of institutional changes on global efficiency of the Romanian economy. Admitting that the long-run equilibrium is characterised by  $\text{rAIGFCFc}=0.02$ ,  $\text{rDDP}=0$ ,  $\text{maru}=0.04$ , and  $\alpha=\alpha_{\text{hao}}$ , ITFP as a function of  $t$  (Graph ITFPo) has the following shape:



When  $t \rightarrow \infty$ ,  $\text{ITFPo} \rightarrow 1.039151$ , which is implausible for a developing economy.

#### D. Domestic Absorption

On this subject, three relationships will be examined:

- consumption of households (including private administration),
- public consumption, and
- gross fixed capital formation.

1. Initially, we estimated econometrically the final consumption of households in current prices (CH), starting from:

$$\text{IYD}=\text{YD}/\text{YD}(-1) \quad (\text{II.D.1.1})$$

$$\text{rIYD}=\text{IYD}-1 \quad (\text{II.D.1.2})$$

$$\text{ICH}=\text{CH}/\text{CH}(-1) \quad (\text{II.D.1.3})$$

$$rICH=ICH-1 \quad (II.D.1.4)$$

where:

YD – disposable income, current prices, billion RON, computed as follows:

$$YD=GDP-(BR-TR)+NOCAE*ERE$$

where

GDP – gross domestic product, current prices, billion RON,

BR – general consolidated budget revenues, billion RON,

TR - government transfers, billion RON, including consolidated budget expenditures for social protection

However, the Granger causality test revealed no relationships among the variables.

1.1a. As a result, the values of disposable income and of final consumption of households in real terms are used. As we shall see, for similar reasons, in the case of the gross fixed capital formation, the solution will be different. For the private consumption, we have:

$$IYDc=IYD/PGDP \quad (II.D.1.5)$$

$$rIYDc=IYDc-1 \quad (II.D.1.6)$$

$$ICHc=ICH/CPI \quad (II.D.1.7)$$

$$rICHc=ICHc-1 \quad (II.D.1.8)$$

where

PGDP - gross domestic product deflator

CPI – consumer price index.

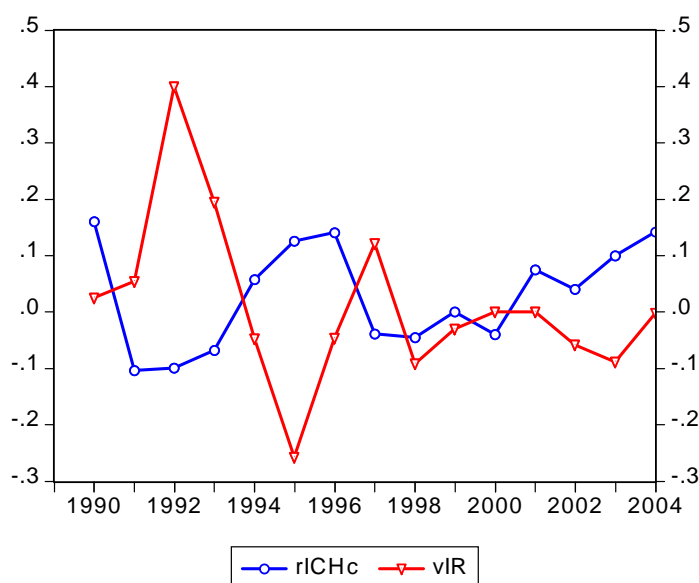
The correlation between  $rICHc$  and  $rIYDc$  is positive (0.641407).

1.1b. The interest rate is considered as an annual change ( $vIR$ ):

$$vIR=IR-IR(-1) \quad (II.D.1.9)$$

where IR – reference interest rate of NBR (Graph  $rICHc-vIR$ ).

Graph  $rICHc-vIR$



The correlation coefficient between  $rICHc$  and  $vIR$  is -0.595247.

1.1c. The first lag of consumption is also included as an explanatory variable.

1.2. Therefore, the following relationship has been regressed:

$$rICHc=c(109)*rIYDc+c(110)*vIR+c(111)*rICHc(-1) \quad (II.D.1.10)$$

with the estimates:

$$c(109)=1.089233$$

$$c(110)=-0.229692$$

$$c(111)=0.432884$$

2. The public consumption (CG) is determined in relation with the general consolidated budget expenditures (BE) and government transfers (TR).

2.1. With this aim, the coefficient

$$ccg1=CG/(BE-TR) \quad (II.D.2.1)$$

is computed.

The Hodrick-Prescott filter indicates an ascending trend of this variable. Obviously, such a tendency cannot continue forever.

2.2. This is why the following specification has been adopted:

$$ccg1=c(112)+c(113)/t \quad (II.D.2.2)$$

with  $c(112)=0.353038$  and  $c(113)=-0.089397$ .

The second coefficient reflects the increasing trend of  $ccg1$ , whilst the first - its asymptotical level.

3. We have an estimation of the final consumption (FC), by summing CH and CG. Due to the simultaneous influence of fiscality, government transfers, and public expenditures on the components of FC, its analysis can reveal some properties of the macromodel regarding the budget policies.

3.1. The final consumption of households is obtained from (II.D.1.10) thus:

$$ICHc=c(109)*rIYDc+1+c(110)*vIR+c(111)*rICHc(-1) \quad (II.D.3.1)$$

$$ICH=CPI*(c(109)*rIYDc+1+c(110)*vIR+c(111)*rICHc(-1)) \quad (II.D.3.2)$$

$$CH=CH(-1)*CPI*(c(109)*rIYDc+1+c(110)*vIR+c(111)*rICHc(-1)) \quad (II.D.3.3)$$

$$rIYDc=IYDc-1=IYD/PGDP-1=YD/(YD(-1)*PGDP)-1 \quad (II.D.3.4)$$

$$CH=CH(-1)*CPI*(c(109)*YD/(YD(-1)*PGDP)-c(109)+1+c(110)*vIR+c(111)*rICHc(-1))= \\ =CH(-1)*CPI*c(109)*YD/(YD(-1)*PGDP)+CH(-1)*CPI*(1+c(110)*vIR+c(111)*rICHc(-1)-c(109)) \quad (II.D.3.5)$$

and substituting:

$$D1=CH(-1)*CPI*c(109)/(YD(-1)*PGDP)$$

$$D2=CH(-1)*CPI*(1+c(110)*vIR+c(111)*rICHc(-1)-c(109))$$

$$CH=D1*YD+D2=D1*(GDP+NOCAE*ERE)-D1*(BR-TR)+D2 \quad (II.D.3.5a)$$

$$D3=D1*(GDP+NOCAE*ERE)+D2$$

$$CH=D3-D1*(BR-TR) \quad (II.D.3.5b)$$

3.2. Based on (II.D.2.2), the public consumption represents

$$CG=ccg1*(BE-TR)=(c(112)+c(113)/t)*(BE-TR) \quad (II.D.3.6)$$

3.3. As a result,

$$FC=CH+CG=D3-D1*(BR-TR)+ccg1*(BE-TR)=D3-D1*BR+ccg1*BE+TR*(D1-ccg1) \quad (II.D.3.7)$$

Some simplifications are useful:

$$ctr=TR/BE$$

$$cbr=BR/GDP$$

$$cbb=(BR-BE)/GDP$$

$$BE=GDP*(cbr-cbb)$$

Therefore

$$FC=D3-D1*cbr*GDP+ccg1*GDP*(cbr-cbb)+ctr*GDP*(cbr-cbb)*(D1-ccg1) \quad (II.D.3.8)$$

3.4. In the case of Romanian economy, using statistical data for 2004, we have

$$D3=224.0513$$

$$D1=0.951546$$

$$ccg1=0.347451$$

$$cbr=0.296073$$

$$ctr=0.479141$$

$$cbb=-0.0114$$

GDP=238.79  
and, respectively

$$FC=224.0513-227.2197*cbr+82.96782*(cbr-cbb)+ctr*144.2518*(cbr-cbb)= \\ =224.0513-144.252*cbr-82.96782*cbb+144.2518*ctr*(cbr-cbb) \quad (II.D.3.9)$$

FC will be successively estimated for different values of the budget parameter (cbr, cbb, and ctr), maintaining the other two at the registered levels.

These conventional series (having the suffix s) are determined through multiplying the corresponding statistical data of 2004 by the simulation coefficient sco (see Table no. IID4);

Three series of FC are computed as follows:

$$FCrS=224.0513-144.252*cbrs-82.96782*(-0.0114)+144.2518*0.479141*(cbrs-(-0.0114)) \quad (II.D.3.10)$$

$$FCbS=224.0513-144.252*0.296073-82.96782*cbbs+144.2518*0.479141*(0.296073-cbbs) \quad (II.D.3.11)$$

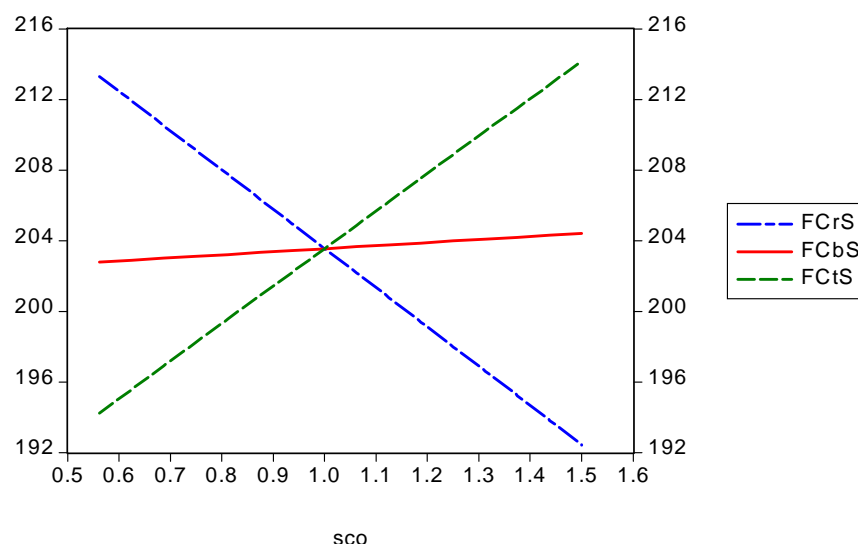
$$FCtS=224.0513-144.252*0.296073-82.96782*(-0.0114)+144.2518*ctrs*(0.296073-(-0.0114)) \quad (II.D.3.12)$$

Depending on sco, they have different slopes, see the Graph FCS.

Table no. IID1

sco	cbrs	cbbs	ctrs
0.5625	0.166541	-0.006413	0.269517
0.6250	0.185046	-0.007125	0.299463
0.6875	0.203550	-0.007838	0.329409
0.7500	0.222055	-0.008550	0.359356
0.8125	0.240559	-0.009263	0.389302
0.8750	0.259064	-0.009975	0.419248
0.9375	0.277568	-0.010688	0.449195
1.0000	0.296073	-0.011400	0.479141
1.0625	0.314578	-0.012113	0.509087
1.1250	0.333082	-0.012825	0.539034
1.1875	0.351587	-0.013538	0.568980
1.2500	0.370091	-0.014250	0.598926
1.3125	0.388596	-0.014963	0.628873
1.3750	0.407100	-0.015675	0.658819
1.4375	0.425605	-0.016388	0.688765
1.5000	0.444110	-0.017100	0.718712

Graph FCS



Therefore, the growing budget revenues tend to compress the final consumption, whilst an increasing coefficient of government transfers stimulates it; the rise of budget deficit extends final consumption, but slightly. Of course, at the intersection point, all three cases are estimated using statistical indicators.

4. As we have already noticed, in the case of Romanian economy, investments are correlated with three explanatory variables:

- disposable income,
- interest rate, and
- foreign capital inflows.

4.1a. The interaction between the disposable income and the rate of gross fixed capital formation has been examined either in current prices (rIGFCF) or in real terms (rIGFCFc):

$$\text{IGFCF} = \text{GFCF} / \text{GFCF}(-1) \quad (\text{II.D.4.1})$$

$$\text{rIGFCF} = \text{IGFCF} - 1 \quad (\text{II.D.4.2})$$

$$\text{IGFCFc} = \text{IGFCF} / \text{PK} \quad (\text{II.D.4.3})$$

$$\text{rIGFCFc} = \text{IGFCFc} - 1 \quad (\text{II.D.4.4})$$

where

GFCF – gross fixed capital formation, current prices, billion RON,

PK – price index of tangible fixed assets (previous year=1).

The nominal indicators revealed clearer the connection between the disposable income and investments.

4.1b. Concerning the second factor, the variation of the reference interest rate of National Bank of Romania (vIR) was considered.

4.1c. The gross fixed capital formation has also been studied in correlation with the index of foreign direct and portfolio investment.

$$\text{IFDPIE} = \text{FDPIE} / \text{FDPIE}(-1) \quad (\text{II.D.4.5})$$

$$\text{rIFDPIE} = \text{IFDPIE} - 1 \quad (\text{II.D.4.6})$$

where:

FDPIE – foreign direct and portfolio investment, billion Euro,

4.2. The gross fixed capital formation is, therefore, estimated as follows:

$$\text{rIGFCF} = c(114) * \text{rIYD} + c(115) * \text{vIR} + c(116) * \text{rIFDPIE} \quad (\text{II.D.4.7})$$

The estimates

$$c(114) = 0.940420$$

$$c(115) = -0.623895$$

$$c(116) = 0.012402$$

are plausible from the economic point of view. The relatively low  $c(116)$  is not a surprise, taking into account that for a long time during transition the foreign capital hesitated to penetrate in Romanian economy.

5. The modification of inventories is computed as a residual.  
 6. The equations concerning the output and domestic absorption have been combined into a mini-system in order to examine the market equilibrium of goods and services:

$$GDP = GDP(-1) * IGDPc * PGDP \quad (II.D.4.8)$$

$$IGDPc = IE^{\alpha} * ICKc^{(1-\alpha)} * ITFP \quad (II.D.4.9)$$

$$ICKc = 1 - dfa + GFCFc / CK(-1) \quad (II.D.4.10)$$

$$ITFP = \alpha - \alpha^{4.533882} * (c(105) + c(106) * rIGFCFc(-1) + c(107) * rIDADc + c(108) * ru(-1)) \quad (II.D.4.11)$$

$$GFCFc = GFCF / PK \quad (II.D.4.12)$$

$$GFCF = GFCF(-1) * (1 + rIGFCF) \quad (II.D.4.13)$$

$$rIGFCF = c(114) * rIYD + c(115) * vIR + c(116) * rIFDPIE \quad (II.D.4.14)$$

$$rIYD = YD / YD(-1) - 1 \quad (II.D.4.15)$$

$$YD = GDP + NOCAE * ERE - (BR - TR) \quad (II.D.4.16)$$

$$rIDADc = DAD / (DAD(-1) * PGDP) - 1 \quad (II.D.4.17)$$

$$DAD = CH + CG + GFCF + STOCK \quad (II.D.4.18)$$

$$CH = CH(-1) * CPI * (1 + rICHc) \quad (II.D.4.19)$$

$$rICHc = c(109) * rIYDc + c(110) * vIR + c(111) * rICHc(-1) \quad (II.D.4.20)$$

$$rIYDc = YD / (YD(-1) * PGDP) - 1 \quad (II.D.4.21)$$

$$vIR = IR - IR(-1) \quad (II.D.4.22)$$

$$CG = ccg1 * (BE - TR) \quad (II.D.4.23)$$

$$ccg1 = c(112) + c(113) / t \quad (II.D.4.24)$$

For simulations, the following indicators are constant (statistical data): GDP(-1), CK(-1), rIGFCFc(-1), ru(-1), GFCF(-1), YD(-1), DAD(-1), CH(-1), rICHc(-1), IR(-1), PGDP, IE, alpha, dfa, PK, ERE, TR, STOCK, CPI, while the variables BR, BE, NOCAE, and rIFDPIE will be changed, generating three cases.

Table no, IID2

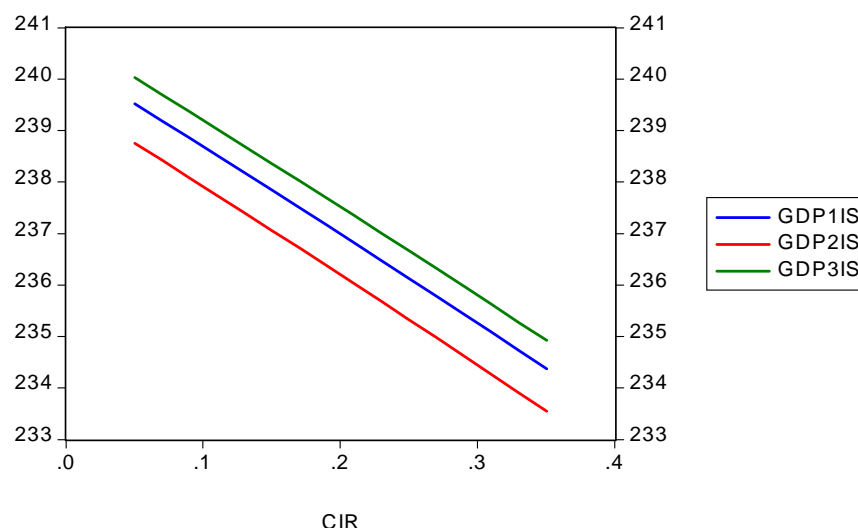
Indicators	Variant 1 (statistical data)	Variant 2	Variant 3
BR	70.7 bill. RON	75.7 bill. RON	70.7 bill. RON
BE	73.423 bill. RON	78.5 bill. RON	73.423 bill. RON
NOCAE	1.134 bill. Euro	1.134 bill. Euro	1.75 bill. Euro
rIFDPIE	0.7045	0.7045	1.1

Compared to the statistical data, the second scenario shows an increased public budget, whilst the third one - indicates greater external financial resources.

The above-presented system is solved for an interest rate varying from 0.05 to 0.35 (denoted CIR). The resulted GDPs represent points on the IS curve and, corresponding to the mentioned computational assumptions, they will be denoted GDP1IS, GDP2IS, and GDP3IS (Graph IS).

The slope of every curve is the usual one. The third case exceeds the statistical data because of the positive influence of increased NOCAE and rIFDPIE on disposable income and investment, respectively. Regarding the second case, the stimulating effect of higher public demand is surpassed by the compressing effect of higher budget taxes on the private sector.

Graph IS



### E. Foreign Trade

1. The export indicators refer to all transactions (either of goods or services).

1.1a. The foreign demand - as an explanatory variable of exports - is expressed through the index of the volume of the world trade. The annual rates have been used:

$$rIXGSE = IXGSE - 1 \quad (\text{II.E.1.1})$$

$$IXGSE = XGSE / XGSE(-1) \quad (\text{II.E.1.2})$$

$$rIWTc = IWTc - 1 \quad (\text{II.E.1.3})$$

where:

XGSE – export of goods and services, billion Euro, and  
IWTc – yearly index of world trade, volume.

1.1b. In the case of the Romanian economy, the influence of import (rIMGSE) is also significant:

$$rIMGSE = IMGSE - 1 \quad (\text{II.E.1.4})$$

$$IMGSE = MGSE / MGSE(-1) \quad (\text{II.E.1.5})$$

where:

MGSE - import of goods and services, billion Euro.

This dependence comes from the fact that the Romanian export industries are essentially based on imported raw materials and energy resources.

1.1c. The competitiveness will be defined as follows:

$$rICOsdr = ICOsdr \quad (\text{II.E.1.6})$$

$$ICOsdr = IERE * WTDsdr / PGDP \quad (\text{II.E.1.7})$$

$$IERE = ERE / ERE(-1) \quad (\text{II.E.1.8})$$

where:

ERE – exchange rate, RON per Euro,

WTDsdr – world trade deflator, SDRs, and

PGDP – gross domestic product deflator.

Taking into account the structure of Romanian commercial changes, the world trade deflator in special drawing rights has been considered more adequate than other deflators.

Due to the gradual transition from command to market economy, the influence of international competitiveness on export manifested itself step-by-step, also. Computed for successive intervals, the Granger causality test suggested such a trend.

1.2. Consequently, the following expression has been estimated:

$$rIXGSE = c(117) * rIWTc + c(118) * rIMGSE + (c(119) + c(120)/t) * rICOsdr \quad (\text{II.E.1.9})$$



Since the effect of competitiveness is perturbed in transition by continuously changing institutional framework, the parameter  $t$  tries to depict the presence of these other factors. The obtained estimates are:

$$c(117)=1.539479$$

$$c(118)=0.549286$$

$$c(119)=1.147207$$

$$c(120)=-6.246695$$

Therefore, the world demand and Romanian import exercise a major impact on exports' dynamics. As it was supposed, the negative influence of specific transition circumstances attenuates (the coefficient  $c(120)$  is divided by  $t$ ), enforcing instead the positive effect of international competitiveness.

2. The import is also considered in an extended acceptance (goods and services together).

2.1a. Its dependence on the domestic absorption is present in the Romanian economy. This connection will be analysed through the following indicators:

$$rIFC_c = IFC_c - 1 \quad (\text{II.E.2.1})$$

$$IFC_c = FC / (FC_{(-1)} * CPI) \quad (\text{II.E.2.2})$$

$$FC = CH + CG \quad (\text{II.E.2.3})$$

$$rIGFCF_c = IGFCF_c - 1 \quad (\text{II.E.2.4})$$

$$IGFCF_c = GFCF / (GFCF_{(-1)} * PK) \quad (\text{II.E.2.5})$$

where:

CH – final consumption of households, current prices, billion RON,

CG – public consumption, current prices, billion RON,

CPI – consumer price index (previous year=1),

GFCF – gross fixed capital formation, current prices, billion RON,

PK – price index of tangible fixed assets (previous year=1).

In the import specification, the annual rates ( $rIMGSE$ ) are used.

2.1b. Similarly to the export equation, the international competitiveness plays an increasing role.

2.2. As a result, the following specification has been adopted:

$$rIMGSE = c(121) * rIFC_c + c(122) * rIGFCF_c + (c(123) + c(124)/t) * rICO_{sdr} \quad (\text{II.E.2.6})$$

The estimates of regression are:

$$c(121)=0.881613$$

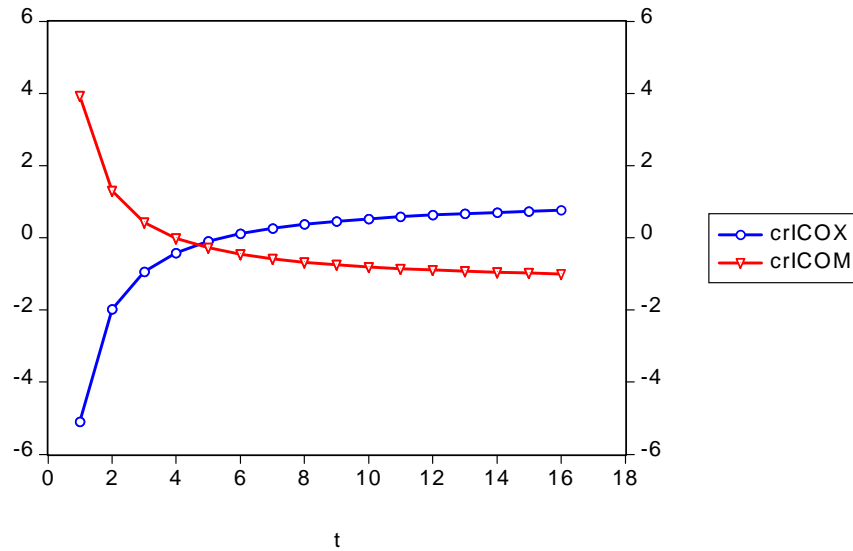
$$c(122)=0.479502$$

$$c(123)=-1.333592$$

$$c(124)=5.270432$$

The influence of competitiveness (normally, negative in this case) is also increasing, as a result of the progressive consolidation of the new market mechanisms. The Graph  $crICO$  compares the evolution of this influence either for exports (suffix X) or for imports (suffix M) (Graph  $crICO$ ).

Graph  $crICO$



## F. Prices and Exchange Rate

1. We admit the gross domestic product deflator (PGDP) as a leading price index. It is obtained

$$PGDP = IGDP / IGDP_c \quad (\text{II.F.1.1})$$

as the ratio between of the indices of nominal and real gross domestic product. In such a determination, this seems to be the most representative expression of the supply-demand interaction.

The consumer price index (CPI) and the price index of tangible fixed assets (PK) are, therefore, estimated in two phases: first as econometric equations and, subsequently, as components of the GDP deflator.

2. As we already mentioned, the consumer price index will be estimated as a function of the broad money and the exchange rate.

2.1. All variables are expressed as rates:

$$rCPI = CPI - 1 \quad (\text{II.F.2.1})$$

$$rIM2 = IM2 - 1 \quad (\text{II.F.2.2})$$

$$IM2 = M2 / M2(-1) \quad (\text{II.F.2.3})$$

$$rIERE = IERE - 1 \quad (\text{II.F.2.4})$$

$$IERE = ERE / ERE(-1) \quad (\text{II.F.2.5})$$

where

M2 – broad money, billion RON,

ERE – exchange rate, RON per Euro.

The dependence of CPI on exchange rate seems to be significant.

Instead, its link to the broad money appears to be weaker, as a consequence of the monetary distortion, discussed in the first chapter. Despite this perturbing influence, the connection between M2 and CPI, nevertheless, could not be cancelled. Even in the case of the Romanian economy, it becomes more and more important. Due to these considerations, the money supply has been maintained as an explanatory variable of the consumer price index.

2.2. For the discussed specification:

$$rCPI = c(125) * rIM2 + c(126) * rIM2(-1) + c(127) * rIERE \quad (\text{II.F.2.6})$$

the following estimates have been obtained:

$$c(125) = 1.301687$$

$$c(126) = -0.431781$$

$$c(127) = 0.364416$$

The sum  $(c(125) + c(126))$  is positive and relatively high (0.869906), which means that a long-run lax monetary policy results in significant inflation. Nevertheless, the negative sign of  $c(126)$  maybe interpreted not

only as an “ingredient of regression”, but also as an expression of the beneficial effect of the remonetisation of the Romanian economy on its output.

3. A similar approach will be adopted for the index of tangible fixed assets.

3.1. The broad money and the exchange rate are considered also as the most important explanatory variables of this index.

3.2. For the specification

$$rPK=c(128)*rIM2+c(129)*rIM2(-1)+c(130)*rIERE \quad (II.F.3.1)$$

the following estimates have been obtained:

$$c(128)=0.973489$$

$$c(129)=-0.256703$$

$$c(130)=0.339649$$

4. Now, it is necessary to introduce an explicit connection between the consumer price index and the index of tangible fixed assets with the gross domestic product deflator.

4.1. This is why the above relationships will be amended with a corrective coefficient PRC, resulted from the assumed condition:

$$PGDP=shch*CPI+shgfcf*PK \quad (II.F.4.1)$$

where:

$$shch=CH/(CH+GFCF) \quad (II.F.4.2)$$

and

$$shgfcf=GFCF/(CH+GFCF) \quad (II.F.4.3)$$

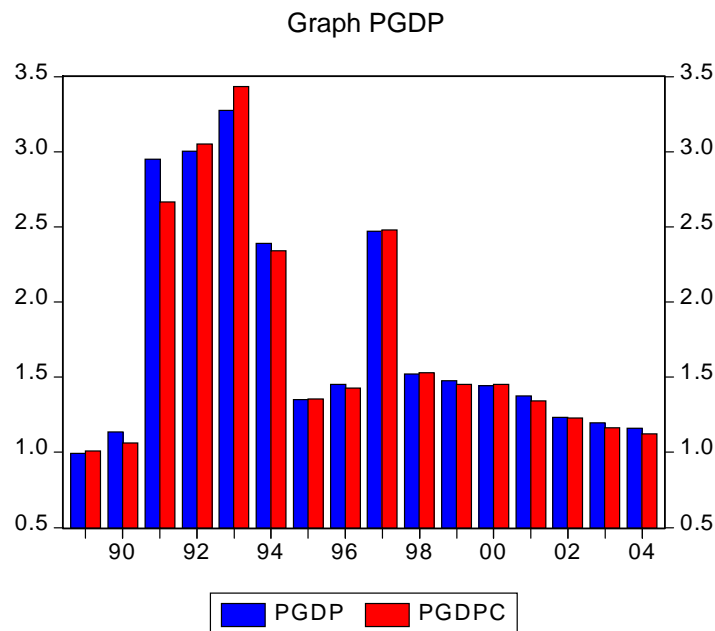
Therefore

$$shch+shgfcf=1 \quad (II.F.4.4)$$

Using statistical data for CPI, PK, shch, and shgfcf, the index

$$PGDPC=shch*CPI+shgfcf*PK \quad (II.F.4.5)$$

has been calculated. It is presented, comparatively to the actual PGDP (Graph PGDP).



The differences between PGDP and PGDPC are so small, that the here-discussed assumption seems realistic. Consequently, the corrective coefficient PRC is obtained from:

$$CPI=(1+rCPI)*PRC \quad (II.F.4.6)$$

$$PK=(1+rPK)*PRC \quad (II.F.4.7)$$

$$PGDP=shch*(1+rCPI)+shgfcf*(1+rPK) \quad (II.F.4.8)$$

where rCPI and rPK are econometric estimations.

5. In the case of Romanian economy - beside the inertial effect - two factors were considered essential for the determination of the exchange rate: domestic inflation and foreign capital inflows.

5.1. In the statistical analysis, the yearly rates are again involved:

$$rIERE=IERE-1 \quad (II.F.5.1)$$

$$IERE=ERE/ERE(-1) \quad (II.F.5.2)$$

$$dPGDP=PGDP-PGDP(-1) \quad (II.F.5.3)$$

$$rINCINXE=INCINXE-1 \quad (II.F.5.4)$$

$$INCINXE=NCINXE/NCINXE(-1) \quad (II.F.5.5)$$

$$NCINXE=NCINE+XGSE \quad (II.F.5.6)$$

$$NCINE=NOCAE+FDPIE \quad (II.F.5.7)$$

where:

ERE – exchange rate, RON per Euro,

PGDP – gross domestic product deflator,

XGSE – export of goods and services, billion Euro,

NOCAE – net incomes and current transfers, billion Euro,

FDPIE – foreign direct and portfolio investment, billion Euro.

5.2. For the specification

$$rIERE=c(131)*rIERE(-1)+c(132)*dPGDP+c(133)*rINCINXE \quad (II.F.5.8)$$

the following estimates have been obtained:

$$c(131)=1.396582$$

$$c(132)=0.879575$$

$$c(133)=-0.797673$$

The high value of the coefficient c(131) is a consequence of a specific transition circumstance, namely the strong expectation of households and firms for the depreciation of the local currency.

The current inflation plays also an important role.

The most interesting is the parameter c(133), which suggests an increasing dependence of the Romanian economy on international financial markets.

## G. Interest Rate

1. The development of market mechanisms progressively enforced the functional role of the monetary variables in the Romanian economy.

1.1. Among them, the interest rate holds a particular place.

1.1a. This version of Romanian macromodel includes inflation and real output as explanatory factors for the interest rate through their cumulative expression – nominal GDP. Thus the reference interest rate of NBR (IR) is compared with rIGDP (=GDP/GDP(-1))

1.1b. The connection between the interest rate and the money supply will be examined through rIM2 (=M2/M2(-1)-1).

1.1c. Considering the geographical structure of the commercial and financial flows that take place in the Romanian economy, the short-term interest rate in advanced countries (STIRAE) has been considered relevant for the present analysis.

1.2. As a result, we decided to use the relationship

$$IR=c(134)*IR(-1)+c(135)*rIGDP+c(136)*rIM2+c(137)*STIRAE \quad (II.G.1.1)$$

with the estimates:

$$c(134)=0.635173$$

$$c(135)=0.277731$$

$$c(136)=-0.179612$$

$$c(137)=0.928214$$

that seem to be plausible.

2. This equation can be used in order to approximate a LM curve:

$$c(135)*rIGDP=IR-((134)*IR(-1)+c(136)*rIM2+c(137)*STIRAE) \quad (II.G.2.1)$$

$$c(135)*(IGDP-1)=IR-((134)*IR(-1)+c(136)*rIM2+c(137)*STIRAE) \quad (II.G.2.2)$$

$$IGDP=(IR-((134)*IR(-1)+c(136)*rIM2+c(137)*STIRAE))/c(135)+1 \quad (II.G.2.3)$$

$$GDP=((IR-((134)*IR(-1)+c(136)*rIM2+c(137)*STIRAE))/c(135)+1)*GDP(-1) \quad (II.G.2.4)$$

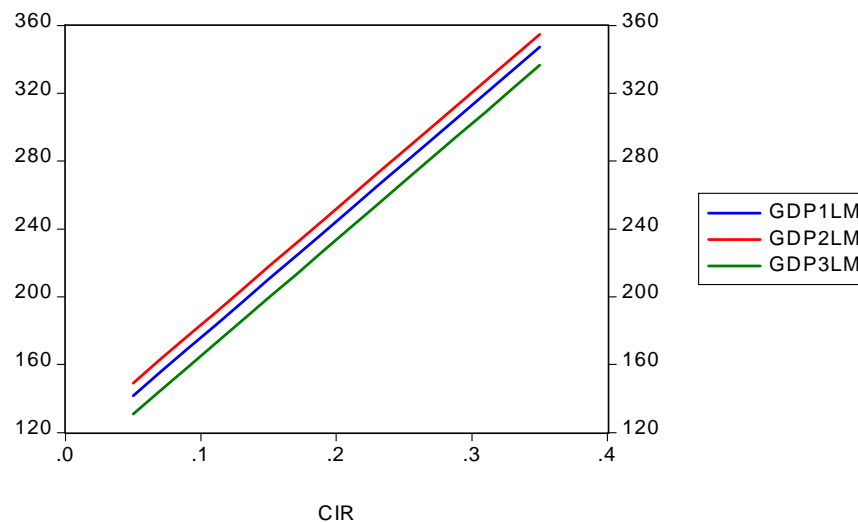
Starting from the data for 2004, three cases are considered again simulated.

Table no, IIG1

Indicators	Variant 1 (statistical data)	Variant 2	Variant 3
rIM2	0.139185	0.2	0.139185
STIRAE	0.018	0.018	0.035

These cases are computed for an interest rate varying from 0.05 to 0.35 (CIR). The resulted GDPs represent points on the LM curve; they will be denoted GDP1LM, GDP2LM, and GDP3LM (Graph LM).

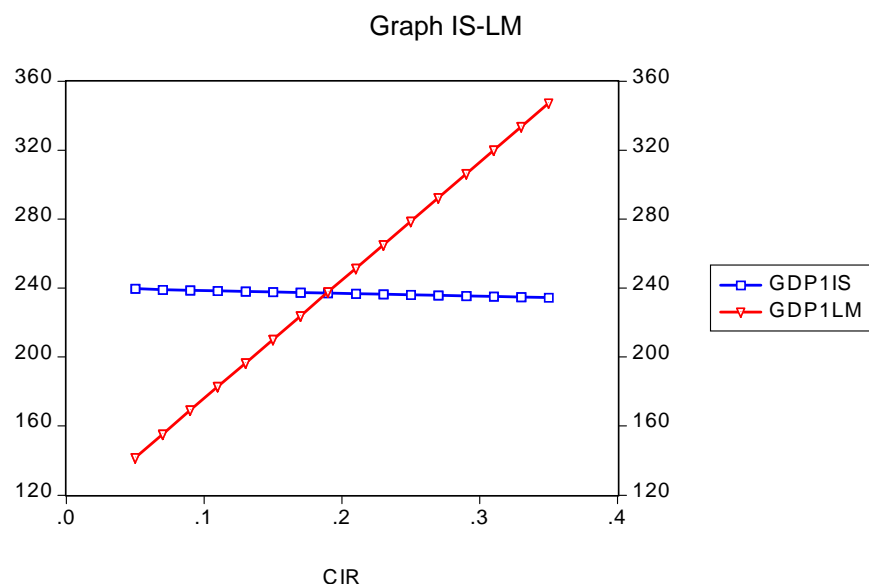
Graph LM



The negative effect of a higher interest rate on international markets is obvious and to be expected. Concerning the second case, we must be more cautious, the remonetisation has authentic positive consequences only if inflation is maintained under control (our exercise does not specify the potential sources of GDP changes).

3. We finish this discussion presenting, for the basic case (GDP1), the intersection of both IS and LM curves (Graph IS-LM).

Therefore, the intersection of the two curves takes place at the interest rate of around 0.19 and at GDP of 237-238 billion RON. For comparison, consider the figures for 2004 which were 0.2 for the interest rate and 238.8 for the GDP. Recall that both GDP1IS and GDP1LM were computed using statistical indicators of this year.



The slopes of IS and LM curves need some explanations. The configuration of IS - almost horizontal – reflects the high rigidity of the real economy to stimuli of the monetary policy. Three causes are probably responsible.

- For a relatively long period, many state companies have tried to survive even with financial losses in order to preserve the existing jobs and avoid an excessive increase in the unemployment.
- Some important sectors of the Romanian economy were compressed as a consequence of restructuring reforms independently of the interest rate and other monetary variables.
- The fracture between the real and nominal economies has been sustained by the above-mentioned monetary distortion, especially by arrears, as a perverse money substitute.

### Chapter III Main Scenario for 2005-2010 years

The macromodel starts from the statistical data of previous years and several exogenous indicators, specific for the current year, which are separately obtained or extracted from other forecasts.

1. Among them, the expected index of disposable income ( $IY_D^{exp}$ ) plays a leading role.

The experience of Romania showed that, in order to minimise the already produced losses and the future potential losses induced by inflation, the economic agents and trade unions exert a considerable pressure towards obtaining certain increases of nominal income; many of which are beforehand negotiated and agreed. The probability to fulfil such expectations proved significant. The budgetary policy (main public revenues and expenditures) is also in advance defined. There are more and more credible methods to approximate the possible transfers from abroad.

For the present version of macromodel, we consider the estimation of  $IY_D^{exp}$  as given. Obviously, in the future, the situation may change substantially. The structure of the macromodel allows switching to other - eventually more relevant – targets.

2. The public budget is estimated using the following exogenous coefficients:

- $vato$  – ratio (to GVA) of the value added tax, excises duties and other similar indirect taxes;
- $cd$  – ratio (to import of goods and services expressed in RON) of the custom duties;
- $dtobr$  – ratio (to GDP) of the direct taxes and other revenues (excluding indirect taxes) of the general consolidated budget;
- $shnit_i$  - share of the sector  $i$  in total net indirect taxes,  $i=1,2,...,6$ ;
- $ctr$  – ratio (to general consolidated budget expenditures) of the government transfers;
- $obe$  – ratio (to GDP) of other expenditures (excluding government transfers) of the general consolidated budget;
- $subp$  – ratio (to general consolidated budget expenditures) of the budget subsidies on goods.

Deliberately, the present version of the macromodel contains a compendious structure of the general consolidated budget. Its future improvements will considerably develop this section.

3. The monetary policy is represented by the broad money ( $M2$ ), under the control of the Central Bank.

4. The international environment is characterised by the following parameters:

- NOCAE - net incomes and current transfers, billion Euro;
- FDPIE – foreign direct and portfolio investment, billion Euro;
- IWTc – yearly index of world trade, volume;
- WTDsdr – world trade deflator, SDRs;
- STIRAE - short-term interest rate in advanced economies.

These and other similar information may be obtained from the forecasts of the international financial institutions and of specialised research centres. As in the case of public budget indicators, the next versions of the macromodel could significantly extend the range of indicators regarding the international context (regional disaggregation, state of the foreign financial markets etc).

5. The number of population over 15 years (AP) – involved in the determination of labour force – is extracted from the demographic projections. Finally, the rate of tangible fixed assets depreciation (dfa) is set exogenously.

### A. Computational Hypothesis

1. The exogenous variables were defined according to the following premises:

- a) the inflationary expectations are significantly diminishing in time, so the index of the expected disposable income is decreasing;
- b) the re-monetisation of the Romanian economy continues, but the reduction of the money velocity is induced simultaneously with a gradual normalisation of price dynamics;
- c) the foreign capital inflows are stationary or are moderately increasing;
- d) the public budget coefficients are aligned to the parameters of the last Pre-Accession Economic Programme for the 2005-2008 interval; the corresponding final values are extrapolated for the 2009-2010 years;
- e) the rate of tangible fixed assets depreciation represents 0.05, which corresponds to an average period of utilization of 20 years (considered by experts as realistic for the Romanian economy);
- f) the external environment is relatively stable, no possible shocks coming from this direction were considered;
- g) the projections of the population above 15 years of age are conform to the current demographic projections;

Table III.1 presents the values of the exogenous variables for each year.

Table IIIA1  
The exogenous variables for the main scenario

Variables	Symbol	2005	2006	2007	2008	2009	2010
Expected index of disposable income	$IY_D^{exp}$	1.135	1.135	1.1325	1.125	1.105	1.085
Population over 15 years, mln. persons	AP	18.12	18.124	18.095	18.066	18.06	18.056
Short term interest rate in advanced economies	STIRAE	0.02	0.02	0.018	0.018	0.018	0.018
Foreign capital inflows, bn. Euro	FDPIE	4.75	4.75	4.75	4.85	5.25	5.5
Net incomes and current transfers, bn. Euro	NOCAE	1.5	1.75	1.75	1.85	2.25	2.5
Broad money, bn. RON	M2	74.28	90	108	130	156	197
World trade deflator	WTDsdr	1.034	1.034	1.034	1.034	1.034	1.034
World trade index, in volume	IWTc	1.045	1.045	1.045	1.045	1.045	1.045
Rate of tangible fixed assets depreciation	dfa	0.05	0.05	0.05	0.05	0.05	0.05
Time	t	17	18	19	20	21	22
Ratio (to GDP) of the direct taxes and other revenues (excluding indirect taxes) of the general consolidated budget;	dtobr	0.207	0.198	0.191	0.186	0.186	0.186
Ratio (to GDP) of other expenditures (excluding government transfers) of the general consolidated budget	obe	0.1837	0.1831	0.1809	0.1826	0.1826	0.1826
Ratio (to GVA) of the value added tax, excises duties and other similar indirect taxes	vato	0.1371	0.1429	0.144	0.1463	0.1463	0.1463
Ratio (to import of goods and services expressed in RON) of the custom duties	cd	0.015	0.015	0.015	0.014	0.014	0.014
Ratio (to general consolidated budget expenditures) of the government transfers	ctr	0.455	0.455	0.455	0.455	0.455	0.455
Ratio (to general consolidated budget expenditures) of the budget subsidies on goods	subp	0.014	0.014	0.013	0.012	0.01	0.008

The sectorial structure of the net indirect taxes which results from input-output tables was kept in large.

2. In the area of labour markets, the series on which the econometric functions were estimated are somewhat different from the ones utilised in the Pre-Accession Economic Programme. The comparability of the data was insured by the introduction of equivalence coefficients in the respective equations.

3. The Romanian economy was affected in the last period by some natural negative factors that have delayed effects of 1-2 years. Such influences on output are introduced into relationship of the total factor productivity, using expert estimations.

4. The preliminary solutions have revealed three inertial evolutions, which require special discussion:

- an accentuated growth in household consumption at the expense of compression of the investments;
- an appreciation, small at the beginning and explosive afterwards, of the RON exchange rate;
- a significant increase, in the first years, of the imports with the severe deterioration of the trade

balance;

We do not exclude the possibility that these tendencies result, at least partly, from the function specification and the data series used in regressions. At least as plausible is the explanation that they reflect the real behaviour of the Romanian economy. In the building of the present scenario the second presumption is admitted. From a technical point of view, the equations concerning household consumption, gross fixed capital formation, exchange rate, and import have been completed with corresponding corrective coefficients.

The proposed technique should not be viewed only as a computational exercise. It is motivated by more profound rationale. If the macroeconomic management does not change, the probability of attaining the main scenario is reduced. The probability becomes acceptable only in the case that strong measures for producing the adjustment of the domestic demand, exchange rate and imports are adopted and become effective. In other words, these coefficients should be considered not only as computational ingredients, but also as milestones of macroeconomic policies that must be promoted in this period.

## B. Simulation results

1. The obtained indicators (in an economically plausible solution of the system) are presented in Table III.2.

Table IIIB1  
Main scenario for 2005-2010

Indicators	Symbol	2005	2006	2007	2008	2009	2010
Gross domestic product, current prices, bn. RON	GDP	281.3	317.52	358.74	401.73	443.32	481.17
Yearly Index of the gross domestic product, current prices	IGDP	1.178	1.1288	1.1298	1.1198	1.1035	1.0854
Yearly Index of the gross domestic product, constant prices	IGDPc	1.0497	1.0579	1.0634	1.0641	1.0635	1.0533
Yearly Index of the household consumption, constant prices	ICHc	1.0897	1.0781	1.0727	1.0728	1.0681	1.056
Yearly Index of the gross fixed capital formation, constant prices	IGFCFc	1.0994	1.1199	1.1294	1.1331	1.1279	1.1367
Export of goods and services, bn. Euro	XGSE	23.796	26.83	30.303	34.314	38.682	43.438
Import of goods and services, bn. Euro	MGSE	33.713	37.538	42.492	47.985	55.474	63.908
Ratio (to gross domestic product) of the net export	rNX	-0.1271	-0.1198	-0.1197	-0.1186	-0.1281	-0.1384
Labour force, mln. pers.	LF	9.5479	9.4706	9.4532	9.4101	9.3975	9.38
Employment, mln. pers.	E	8.7929	8.7458	8.7522	8.733	8.7404	8.7389



Unemployment rate	ru	0.0791	0.0765	0.0742	0.0719	0.0699	0.0683
GDP deflator	PGDP	1.1222	1.067	1.0625	1.0524	1.0376	1.0305
Consumer price index	CPI	1.1374	1.0688	1.0682	1.0588	1.0436	1.0404
Exchange rate, RON per Euro	ERE	3.6057	3.5518	3.5236	3.484	3.3822	3.2541
Ratio (to gross domestic product) of the general consolidated budget revenues	br	0.3338	0.3291	0.3229	0.3192	0.3192	0.3192
Ratio (to gross domestic product) of the general consolidated budget expenditures	be	0.337	0.336	0.332	0.335	0.335	0.335
Ratio (to gross domestic product) of the general consolidated budget balance	cbb	-0.0032	-0.0069	-0.0091	-0.0158	-0.0158	-0.0158
Money velocity	v	3.787	3.528	3.3216	3.0902	2.8418	2.4425

Therefore, the reduction in the inflationary expectation induces compression in the nominal GDP whose index decreases from 1.178 in 2005 to 1.0854 in 2010. The growth rate of the real output (IGDP<sub>c</sub>) is increasing with a tendency to stabilize towards the end of the interval. During entire period, the real GDP is increasing by over 40%. It is worth mentioning that the main resources of growth are the total factor productivity and the expansion of the fixed capital. As expected, this evolution is accompanied by a strong dis-inflation.

With respect to domestic demand, conform to the hypothesis adopted; the dynamics of the gross fixed capital formation stays high, while the annual rate of household consumption tends towards 5-6%. In spite of all corrections (mentioned above) introduced in import, and exchange rate equations, the trade balance deficit remains troublesome (11-13% of GDP). This means that the issue of actively stimulating exports and maintaining import expansions within reasonable limits should be a major preoccupation for Government institutions and the National Bank of Romania.

Given the assumptions of the current simulation, the consolidated budget revenue and expenditure is according to the limits described in the Pre-Accession Economic Programme. So is the public deficit rate as a percentage of GDP.

2. Table III.3 presents the indicators derived from the macro-model in comparison to the values from the Pre-Accession Economic Programme for 2005-2008 (PEP).

Table IIIB2  
The model estimations in comparison to the PEP's

	Symbol		2005	2006	2007	2008
Gross domestic product, current prices, bn. RON	GDP	PEP	281.43	322.78	364.38	406.31
		Model	281.3	317.52	358.74	401.73
Yearly Index of the gross domestic product, current prices	IGDP	PEP	1.1786	1.1469	1.1289	1.1151
		Model	1.178	1.1288	1.1298	1.1198
Yearly Index of the gross domestic product, constant prices	IGDP <sub>c</sub>	PEP	1.057	1.06	1.063	1.065
		Model	1.0497	1.0579	1.0634	1.0641
Yearly Index of the household consumption, constant prices	ICH <sub>c</sub>	PEP	1.102	1.063	1.057	1.058
		Model	1.0897	1.0781	1.0727	1.0728
Yearly Index of the gross fixed capital formation, constant prices	IGFCF <sub>c</sub>	PEP	1.098	1.12	1.125	1.127
		Model	1.0994	1.1199	1.1294	1.1331
Export of goods and services, bn. Euro	XGSE	PEP	25.1	28.75	32.5	36.55
		Model	23.796	26.83	30.303	34.314

Import of goods and services, bn. Euro	MGSE	PEP	33.22	37.95	42.65	47.6
		Model	33.713	37.538	42.492	47.985
Ratio (to gross domestic product) of the net export	rNXGS	PEP	-0.1042	-0.1018	-0.0983	-0.0955
		Model	-0.1271	-0.1198	-0.1197	-0.1186
Labour force, mln. pers.	LF	PEP	9.495	9.4942	9.4933	9.4923
		Model	9.5479	9.4706	9.4532	9.4101
Employment, mln. pers	E	PEP	8.7354	8.7346	8.7338	8.7329
		Model	8.7929	8.7458	8.7522	8.733
Unemployment rate	ru	PEP	0.079	0.078	0.076	0.074
		Model	0.0791	0.0765	0.0742	0.0719
GDP deflator	PGDP	PEP	1.115	1.082	1.062	1.047
		Model	1.1222	1.067	1.0625	1.0524
Consumer price index	CPI	PEP	1.09	1.07	1.05	1.036
		Model	1.1374	1.0688	1.0682	1.0588
Exchange rate, RON per Euro	ERE	PEP	3.61	3.57	3.53	3.51
		Model	3.6057	3.5518	3.5236	3.484
Ratio (to gross domestic product) of the general consolidated budget revenues	br	PEP	0.334	0.329	0.322	0.319
		Model	0.3338	0.3291	0.3229	0.3192
Ratio (to gross domestic product) of the general consolidated budget expenditures	be	PEP	0.337	0.336	0.332	0.335
		Model	0.337	0.336	0.332	0.335
Ratio (to gross domestic product) of the general consolidated budget balance	cbb	PEP	-0.003	-0.007	-0.01	-0.016
		Model	-0.0032	-0.0069	-0.0091	-0.0158

## Chapter IV

### Responses to Changes of Exogenous Indicators

The simulations included in this section use the exogenous indicators at the level of the year 2005. One or several of these indicators are arbitrarily modified, all the others being maintained constant at their initial levels. We consider most interesting to study the implications of changes on:

- expected index of disposable income ( $IY_D^{exp}$ );
- inflow of foreign resources (FDPIE and NOCAE);
- general consolidated budget parameters;
- world trade deflator and volume of world trade;
- money supply.

1. The expected index of disposable income changes from 1.1 to 1.4 (in 2005 this was 1.135).

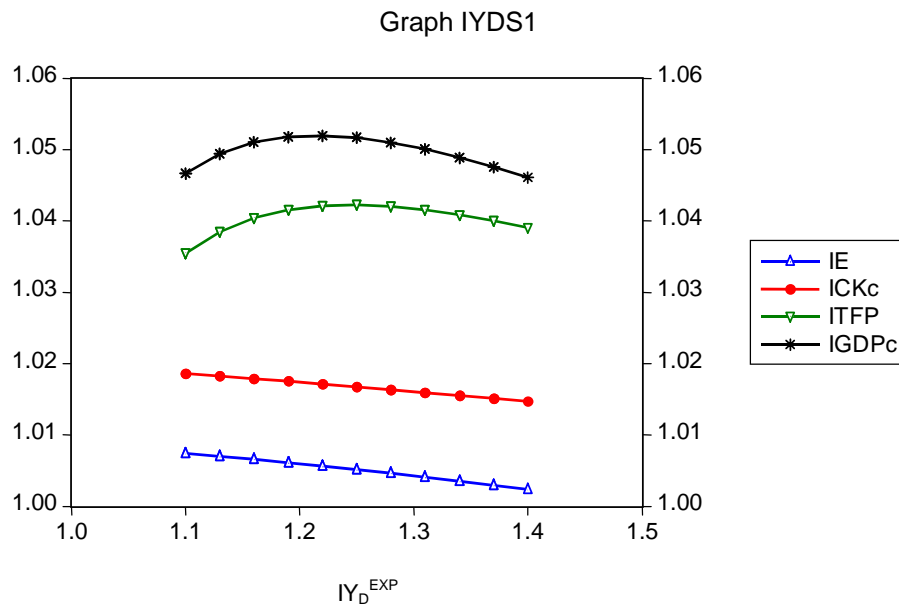
An increase of disposable income (all the other forecasting assumptions remaining constant) translates into the expansion of the nominal demand, which is associated to an accelerating inflation and growing interest rate.

1.1. How does the output react?

The employment registers small changes, its index (IE) reducing from 1.00742 (when  $IY_D^{exp}$  is 1.1) to 1.002422 (for  $IY_D^{exp}=1.4$ ). On the contrary, the contraction of alpha is more accentuated: from 0.695631 to, respectively, 0.643541. This may be considered as an indication that the macromodel correctly reflects the evolution of the Romanian economy, where inflation eroded faster the nominal revenues of households than the gross operating surplus. As a result, the expression  $(\alpha - \alpha^{4.58235724})$  exerts an important effect on the index of total factor productivity.

Due to the increasing interest rate, growing YD generates a reduction of the real gross capital formation, which influences not only the tangible fixed assets (their index at constant prices varies from 1.018571 to 1.014705), but especially the index of total factor productivity.

Graph IYDS1 displays the interaction of these consequences, including their repercussions on index of gross domestic product at constant prices (IGDPc).

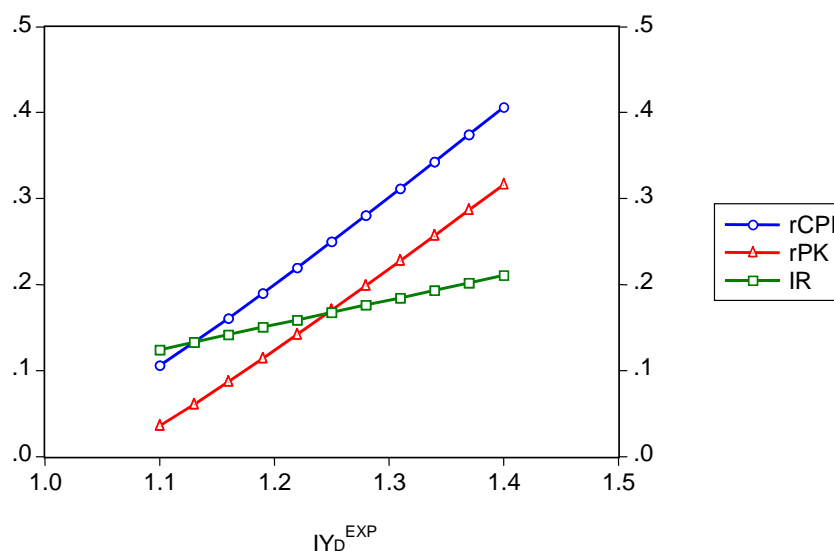


The output curves mimic the behaviour of the index of total factor productivity (ITFP).

1.2. Since the variation of output is limited enough, the growing nominal disposable income inherently translates into inflation, which entails an increasing interest rates (Graph IYDS2). The inflation is measured by the corresponding rates of consumer price index ( $rCPI=CPI-1$ ) and of price index of tangible fixed assets ( $rPK=PK-1$ ).

The discrepancy between inflation and interest rate (IR) comes from the determination of the second one. According to the econometric relationship, IR depends – besides the dynamics of prices - on its previous level (inertia has in this case a great coefficient), and on broad money and foreign interest, that remain constant in simulation.

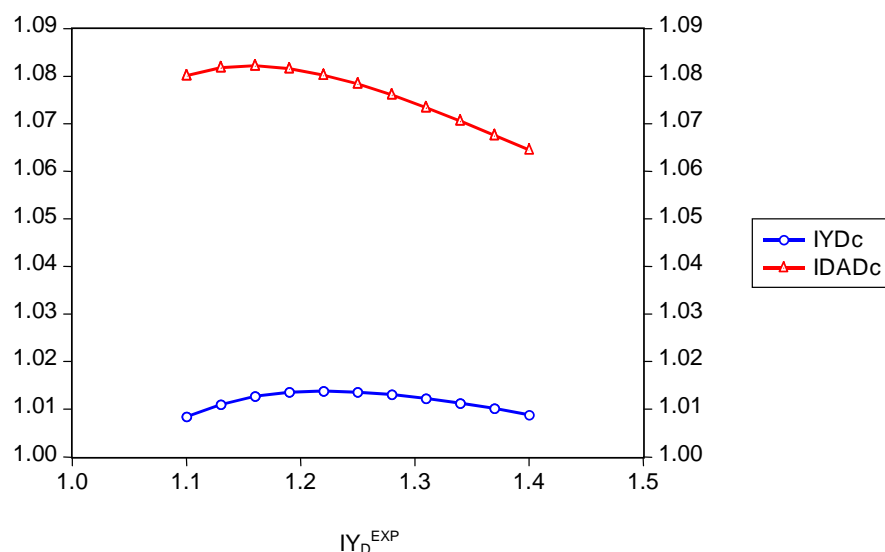
Graph IYDS2



How is then possible for inflation to coexist with stable money supply? The numerical explanation lies in the accommodation of the money velocity. The operational reason consists in the presence of the so-called monetary distortion (especially of extended arrears), which allowed the development of a huge part of transactions without actual money. This way, the ratio GDP/M2 becomes more flexible.

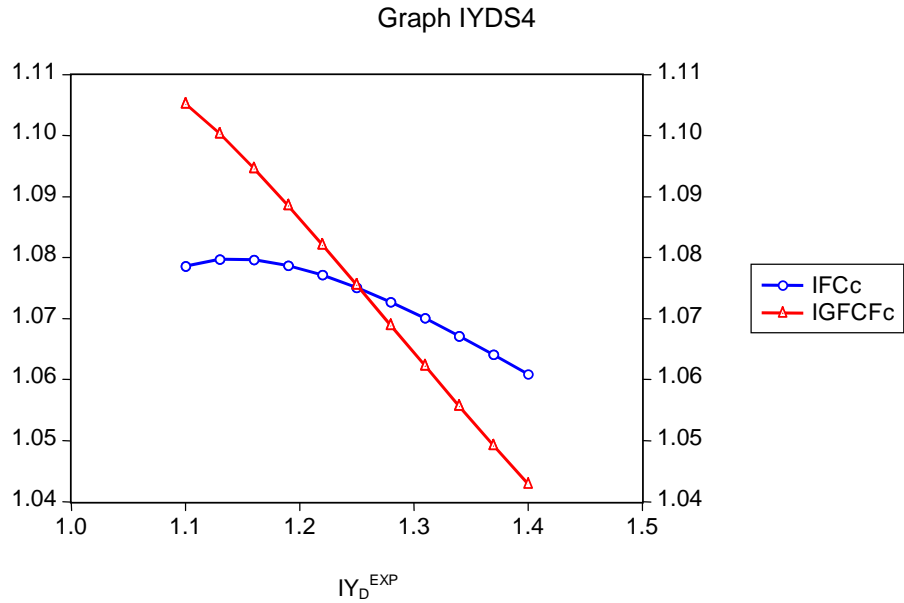
1.3. Because of inflation, the disposable income exerts a noticeably smaller influence on real demand. The Graph IYDS3 presents the indices of disposable income ( $IY_Dc$ ) and of domestic absorption ( $IDADc$ ) deflated by PGDP.

Graph IYDS3

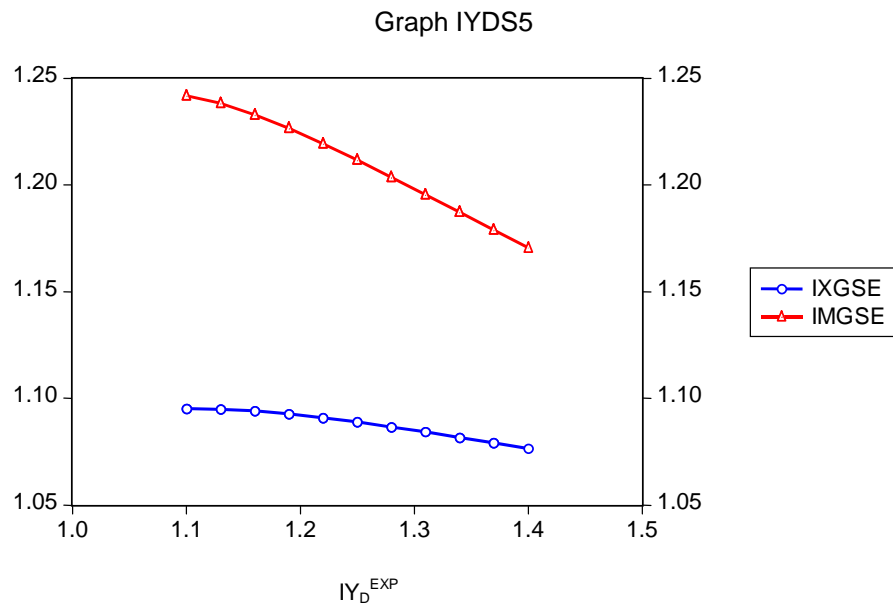


Because of the constancy of NOCAE, the real disposable income follows the trajectory of the real GDP.

1.4. Again as a consequence of inflation, the nominal exchange rate increases, slightly improving the competitiveness: so the index  $ICOsdr$  changes from 0.816858 (when  $IY_D^{exp}$  is 1.1) to 0.845645 (for  $IY_D^{exp}=1.4$ ). This especially affects the imports. In addition, the indices - in real terms - of the final consumption ( $IFC_c$ ) and gross fixed capital formation ( $IGFCFc$ ) also negatively influence the imports (Graph IYDS4).



The decrease of import indices (IMGSE) entails a similar tendency for exports (IXGSE) (Graph IYDS5).



The combined result of these influences is a modification of the ratio of net export to GDP from - 0.128496 (when  $IY_D^{EXP}$  is 1.1) to -0.112741 (for  $IY_D^{EXP}=1.4$ ).

1.5. In the simulated interval the ratio of budget expenditures to GDP is constant. The direct taxes ratio does not change, as well. Only rNIT registers a very small reduction (from 0.139132 to 0.138957); consequently, the public budget deficit changes from -0.003143 to -0.003278.

2. The second simulation takes into account the following modifications of the inflow of foreign resources (noted further  $CIn=FDPIE+NOCAE$ ):

Table no. IV1

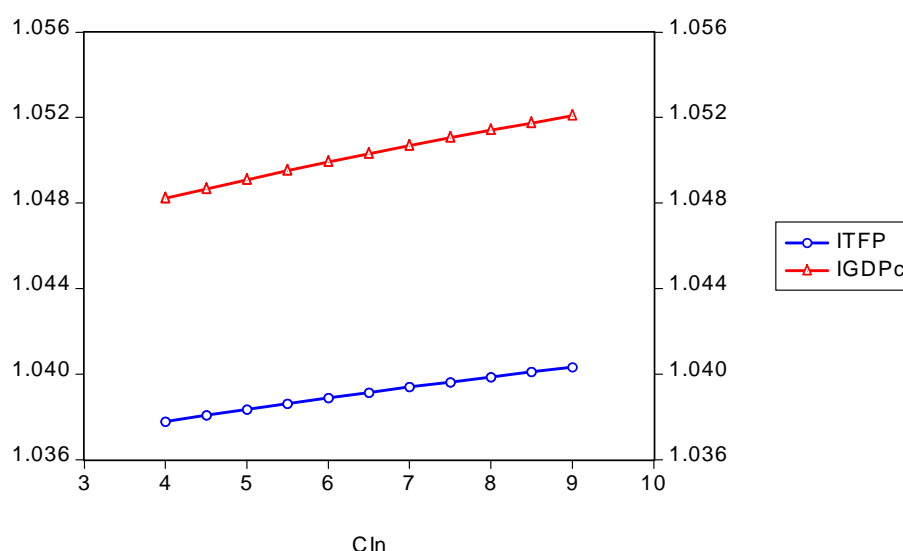
Variant	CIn, bn.Euro	FDPIE, bn.Euro	NOCAE, bn.Euro
1	4	3	1
2	4.5	3.3	1.2
3	5	3.6	1.4
4	5.5	3.9	1.6
5	6	4.2	1.8
6	6.5	4.5	2
7	7	4.8	2.2
8	7.5	5.1	2.4
9	8	5.4	2.6
10	8.5	5.7	2.8
11	9	6	3

Recall that all the other forecasting assumptions remain unchanged. This condition is common for all simulations presented in this chapter.

The inflow of foreign resources influences directly the disposable income, the gross fixed capital formation and the exchange rate, but it has also other implications, which will be discussed in the same succession as in the previous point.

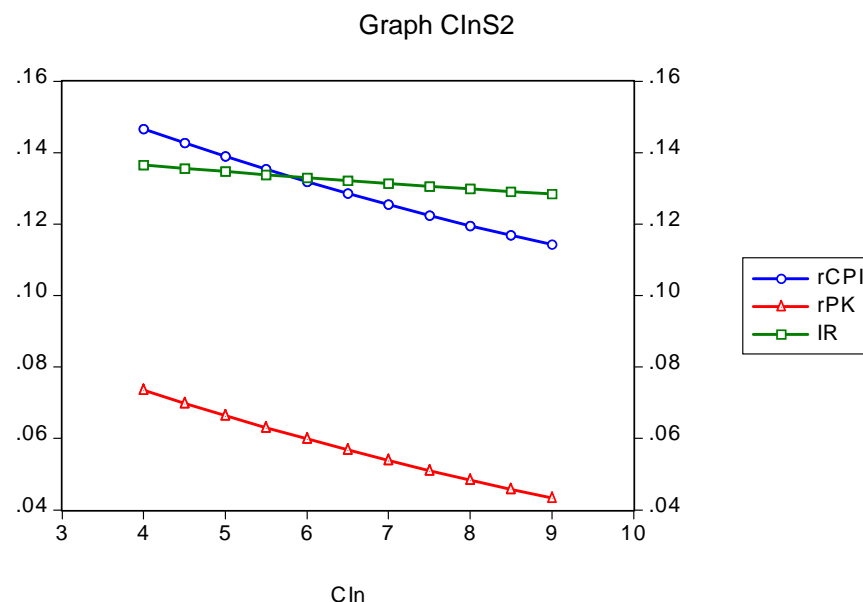
2.1. The index of employment (IE) changes from 1.006778 (when CIn is 4 billion Euro) to 1.007418 (for CIn=9 billion Euro). The index of tangible fixed assets at constant prices (ICKc) also grows, from 1.017292 to, respectively, 1.020064. The expression  $(\alpha - \alpha^{4.58235724})$  insignificantly reduces (from 0.508196 to 0.507309) under rapidly enforcing investment intensity (the index of the gross fixed capital formation at constant prices increases from 1.084555 to 1.129229). As a consequence, the total factor productivity registers higher rates (ITFP), which - together with IE and ICKc - determine a similar trend of output (Graph CInS1).

Graph CInS1



Such behaviour of the macromodel can be also considered suitable. The Romanian economy needs a deep technological restructuring, which would be unfeasible in the absence of substantial foreign capital inflows.

2.2. Under the constancy of nominal disposable income, a clear disinflation (rCPI and rPK) and, correspondingly, diminishing interest rates (IR) accompany the growing output (Graph CInS2).



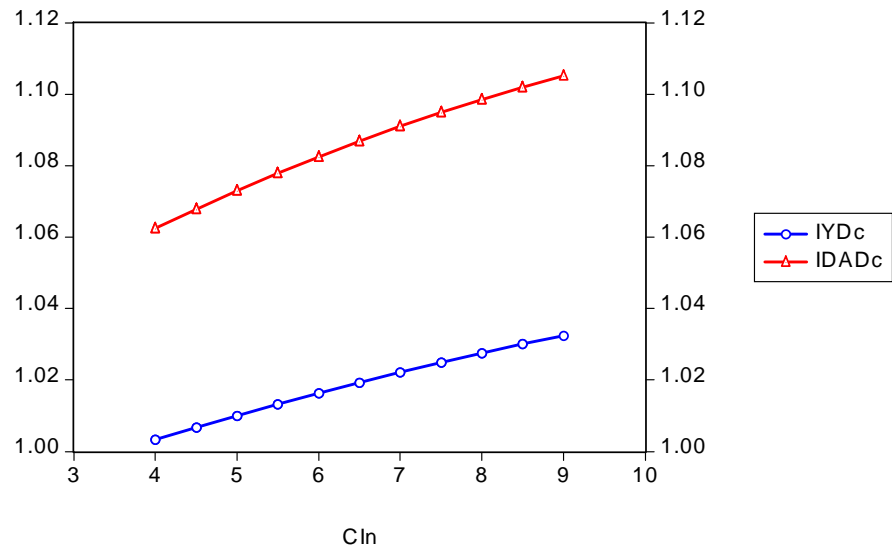
The extremely limited reduction of the interest rate comes from the influence of inertia [econometric coefficient for  $IR(-1)$  is relatively high], and also from the constancy of both STIRAE and, especially, broad money.

This last circumstance does not seem realistic. We must not forget that a large number of Romanian firms were and continue to be undercapitalised. Consequently, it would be difficult to expect a significant economic growth without a rise in the money supply.

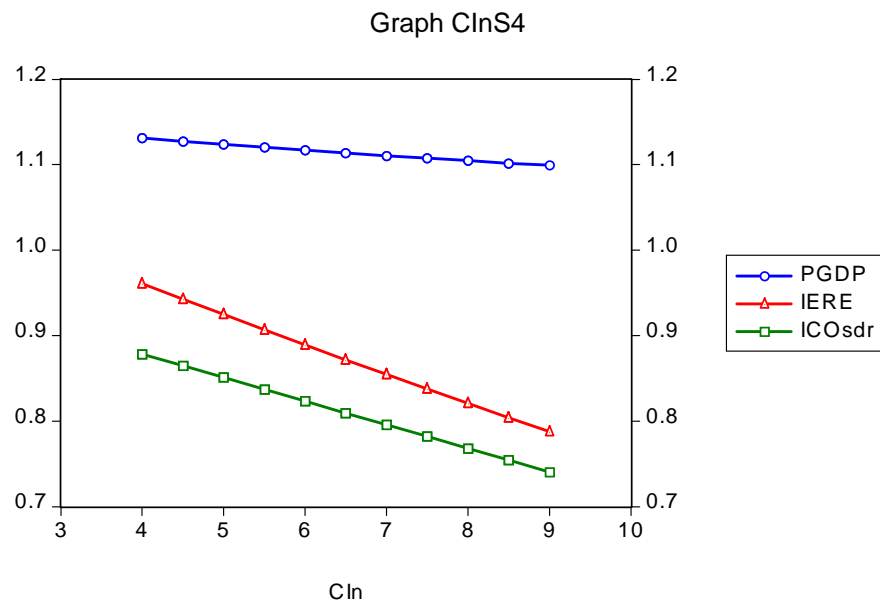
Such weaknesses are unavoidable in simulations based on individual changes in one or several exogenous indicators, the other being maintained fixed. Nevertheless, the direction of change in interest rate in connection with prices dynamics is correctly determined.

2.3. Because of increasing foreign capital inflows, the index of real disposable income lags behind the index of domestic absorption at constant prices )IYDc and IDADc) (Graph CInS3).

Graph CInS3



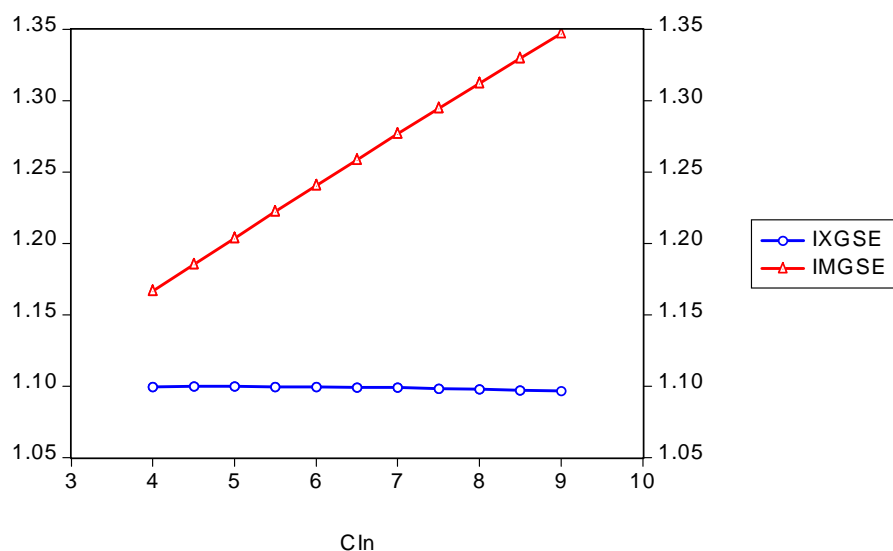
2.4. The same circumstance (growing capital inflows) determines a sensible real appreciation of RON with the corresponding fall of the competitiveness (Graph ClnS4).



The import index (IMGSE) increases, while the export (IXGSE) stagnates (Graph ClnS5).

Graph ClnS5





Consequently, the ratio of net export to GDP changes from  $-0.108367$  (when CIn represents 4 billion Euro) to  $-0.148642$  (for CIn=9 billion Euro).

2.5. The ratio of net indirect taxes to gross value added (rNIT) slightly decreases, with corresponding accentuation of the rate of public budget deficit.

3. Regarding the general consolidated budget, two sets of simulations were performed: one for fiscality, another for budget expenditures.

3a. The ratio (to GVA) of the value added tax, excises duties and other similar indirect taxes (vato) and the ratio (to GDP) of the direct taxes and other revenues (excluding indirect taxes) (dtoabr) change as follows:

Table no. IV2

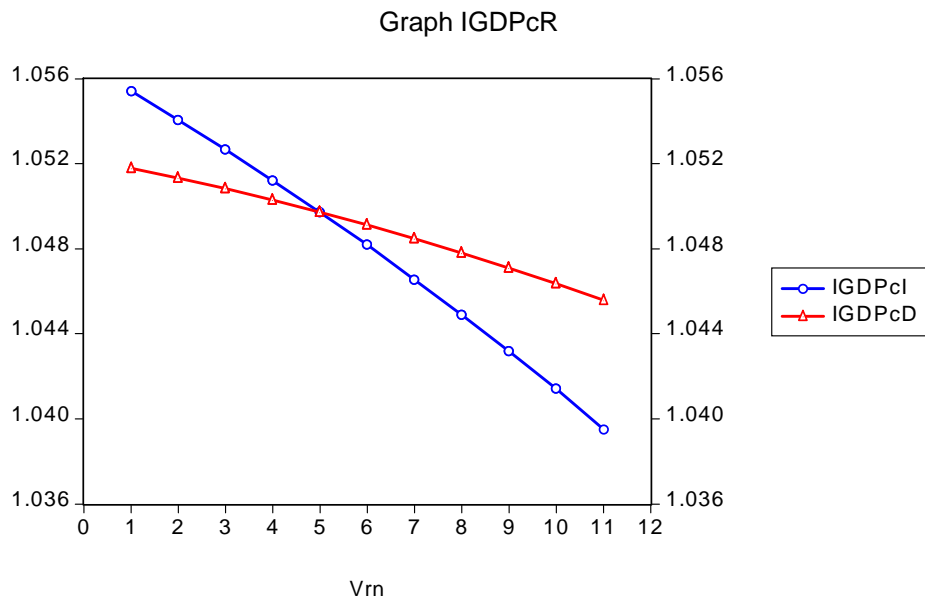
Variant	vato	dtoabr
1	0.1234	0.1863
2	0.1268	0.1915
3	0.1302	0.1967
4	0.1337	0.2018
5	0.1371	0.207
6	0.1405	0.2122
7	0.1440	0.2174
8	0.1474	0.2225
9	0.1508	0.2277
10	0.1542	0.2329
11	0.1577	0.2381

The system has been successively solved for each variant included in table, the budget expenditures being constant. This simulation was conducted exclusively as a redistribution of available resources between public and private sectors. Consequently, the expected index of total disposable income does not change. The

resulted indicators were computed separately for indirect fiscality (vato) and direct taxes (dtobr). In the first case, these have the suffix I and, in the second, the suffix D.

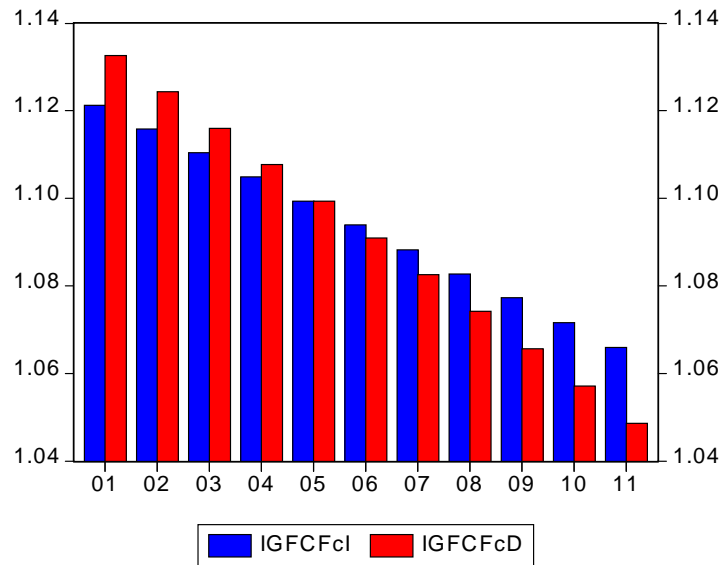
Four categories of consequences seem interesting and have to be discussed in such a simulation: real output (IGDPc), inflation (PGDP), external disequilibrium (rNX) and public budget balance (cbb).

3a.1. The behaviour of the real output is plotted on Graph IGDPcR.



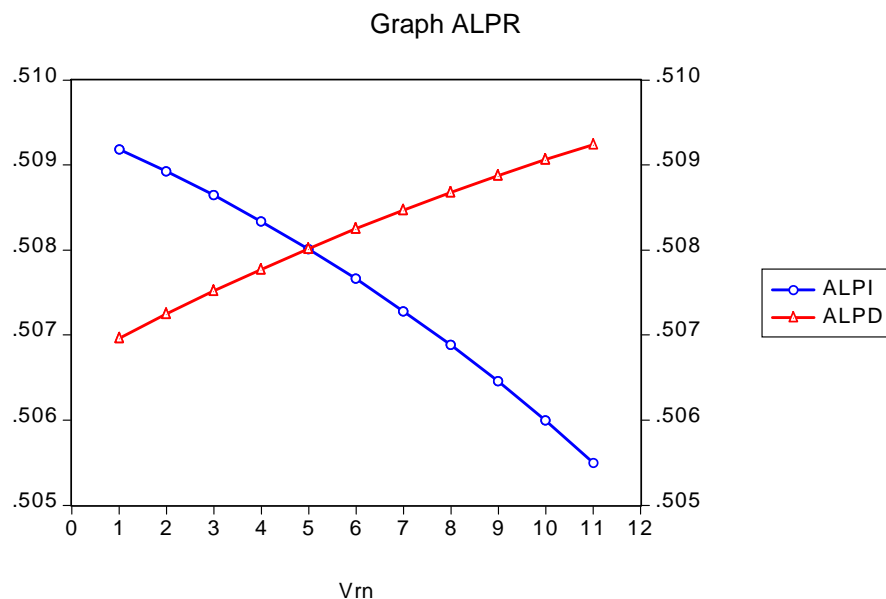
Therefore, if the fiscality is increased, the real output tends to decrease, the decline being steeper for indirect taxation than for the direct one. The main common factor of such influence is the compression of investment (Graph IGFCFcR).

Graph IGFCFcR



The reduction of gross fixed capital formation at constant prices, induced by the higher and higher taxation, generates a corresponding contraction of the production factors. It also negatively affects the index of total factor productivity.

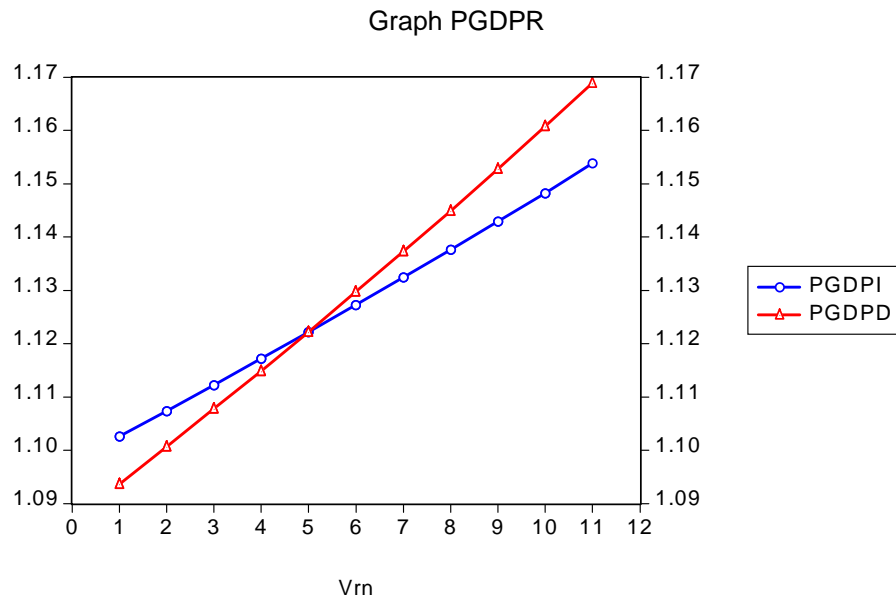
The difference (between the effect of indirect and direct enforcing fiscality on output) comes mainly from the expression  $(\alpha - \alpha^{4.58235724})$ . Its value - noted ALPI and ALPD - changes as follows (Graph ALPR):



What happens? The increasing of indirect fiscality is accompanied by a growing  $\alpha$  (from 0.680079 in variant 1 to 0.697903 in variant 11), whilst a higher direct taxation slightly reduces it (correspondingly, from 0.691925 to 0.679724). The Romanian economy has been characterised by a relatively frequent indexation of wages in correlation with the CPI. There are reasons to believe that the indirect fiscality encouraged such behaviour in a greater measure than the direct one.

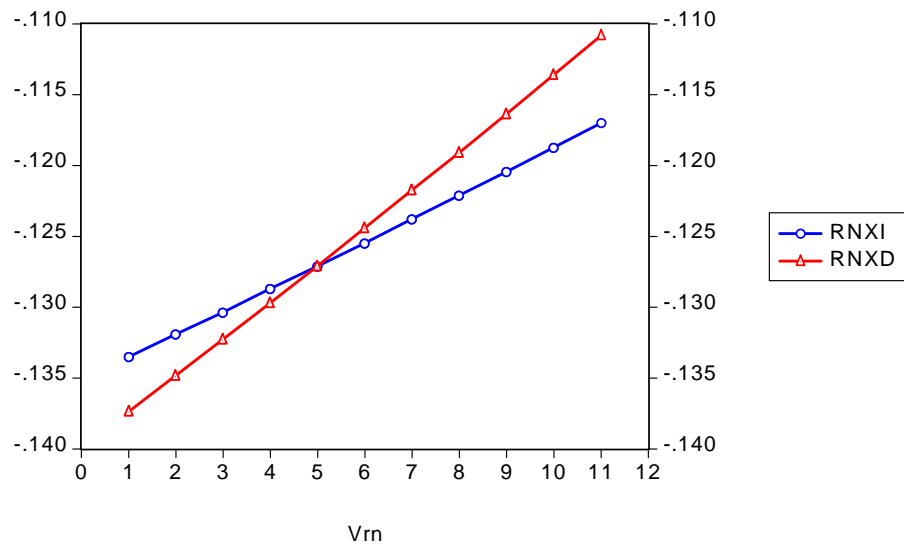
An increasing indirect taxation has in general – and almost unanimously accepted - inflationary effects. As a rule, these are instantaneously anticipated by trade unions, which request a subsequent correction of nominal wages. In the case of enforcing direct taxation, these effects are less visible and the firms have more possibilities to keep the labour income in a certain connection with the labour productivity. In other words, the macromodel seems to correctly reflect the reality.

3a.2. The inflation is presented in Graph PGDPR:

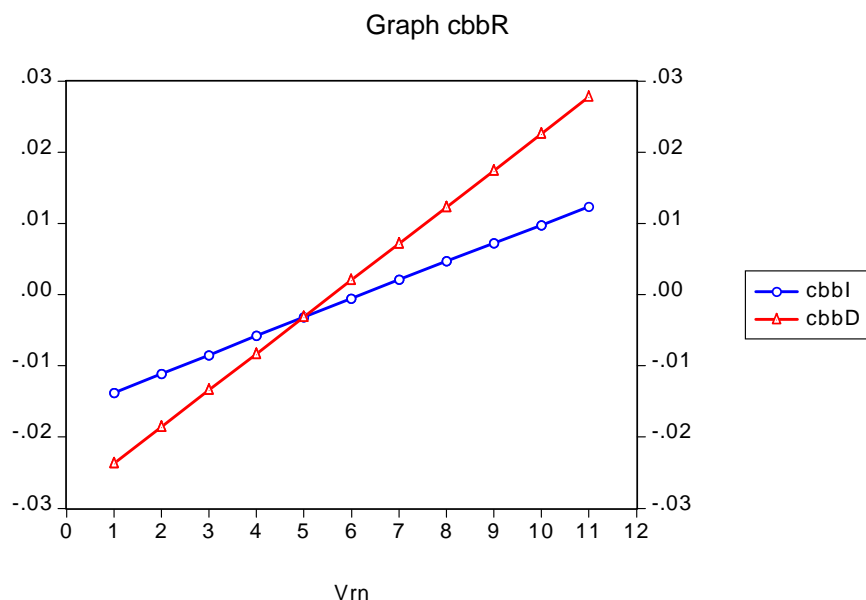


3a.3. The enforcing fiscalty is accompanied by an improvement of the net export ratio to GDP (rNX) (Graph rNXR):

Graph rNXR



3a.4. Recall that the coefficients of budget expenditures (ctr and obe) do not change. Under such circumstances, normally, an increasing fiscalty ameliorates also the public budget balance (cbb), which passes in both cases (higher direct or indirect taxation) from deficits to surpluses (Graph cbbR):



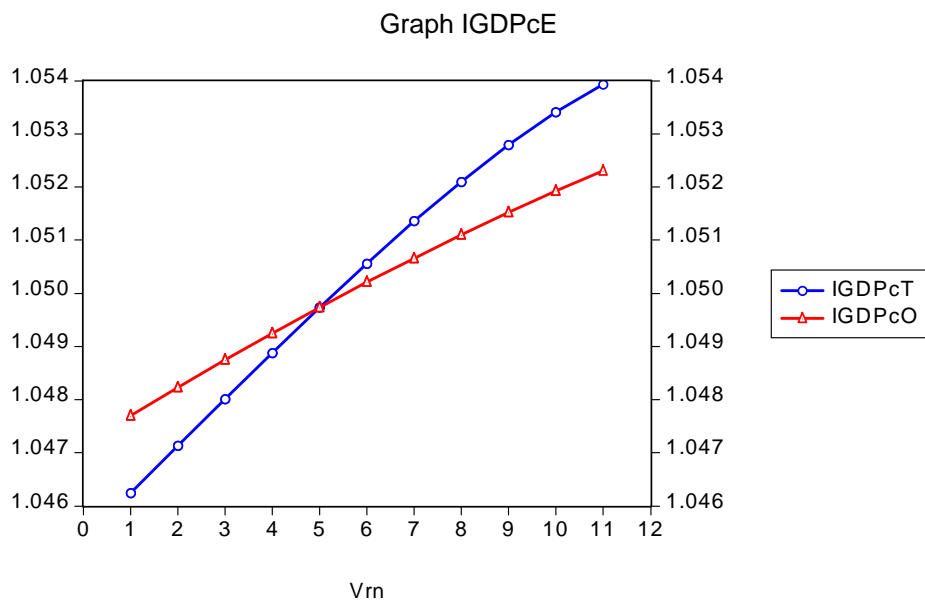
3b. Another series of simulations refers to the budget expenditures, the taxation coefficients remaining constant (vato, cd, dtobr). Again for 11 variants, the following levels of the ratio (to general consolidated budget expenditures) of the government transfers (ctr) and the ratio (to GDP) of the other budget expenditures (obe) have been imposed:

Table no. IV3

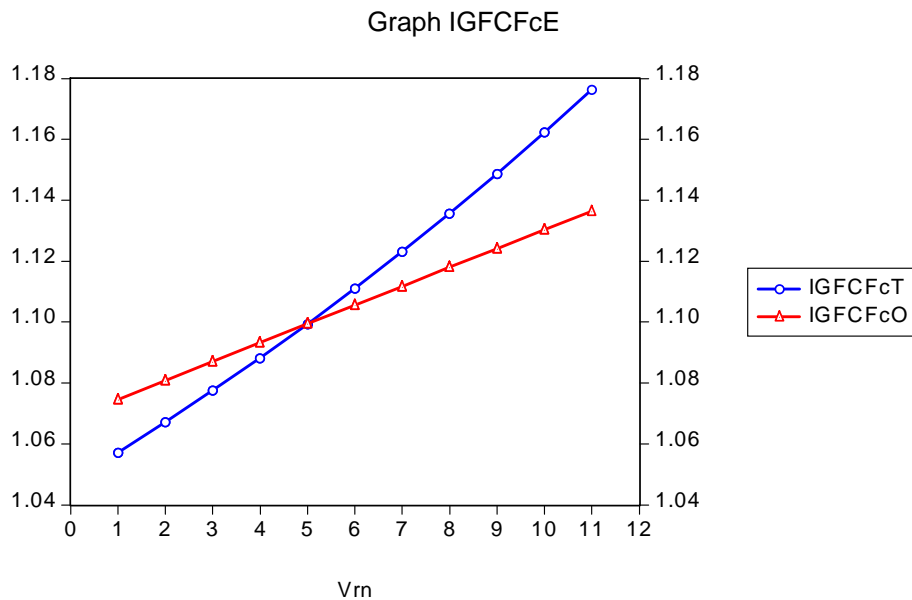
Variant	ctr	obe
1	0.4095	0.1653
2	0.4209	0.1699
3	0.4323	0.1745
4	0.4436	0.1791
5	0.455	0.1837
6	0.4664	0.1883
7	0.4778	0.1928
8	0.4891	0.1975
9	0.5005	0.2021
10	0.5119	0.2067
11	0.5233	0.2113

The resulted indicators are mentioned with the suffix T for the changing ctr and, respectively, O for obe.

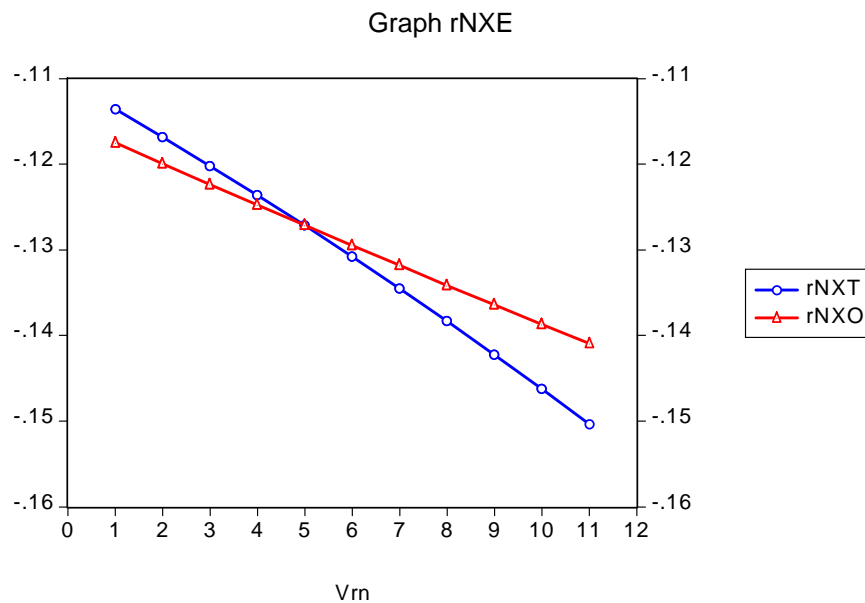
3b.1. Both series of simulations show that increasing budget expenditures stimulates economic growth (Graph IGDPcE):



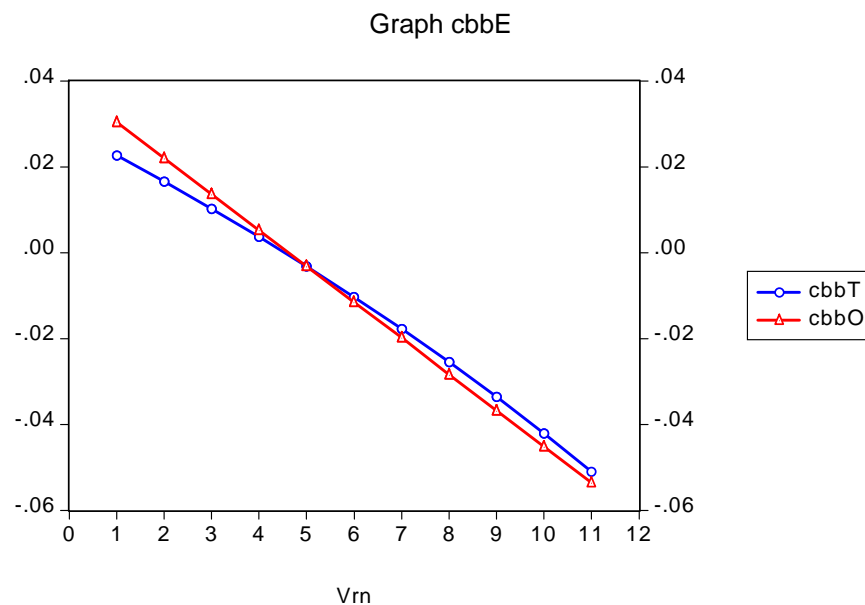
This results especially from the extension of tangible fixed assets and improvement of total factor productivity, both as an effect of increasing indices of fixed capital formation at constant prices (IGFCFc) (Graph IGFCFcE):



3b.2. The expansion of domestic absorption induced by increasing budget expenditures involves a deterioration of the foreign trade balance ( $rNX$ ); this effect is stronger in the case of growing government transfers (Graph  $rNXE$ ):



3b.3. The public budget deficit (expressed by cbb) also accentuates (Graph cbbE):



3b.4. However, increasing budget expenditures are accompanied by a dis-inflation. Such a result becomes from the assumptions adopted in present exercise. We must not forget that the simulation maintains at a constant level the expected disposable income. This hypothesis can hardly be considered probable. It seems plausible to assume that beneficiaries of the public resources, sensing the eventual changes in the government budget policy, adjust their expectations concerning the disposable income. Normally, if the basic disposable income is amended, the results of simulations significantly change.

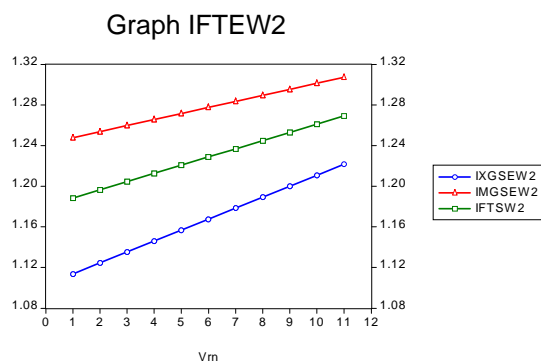
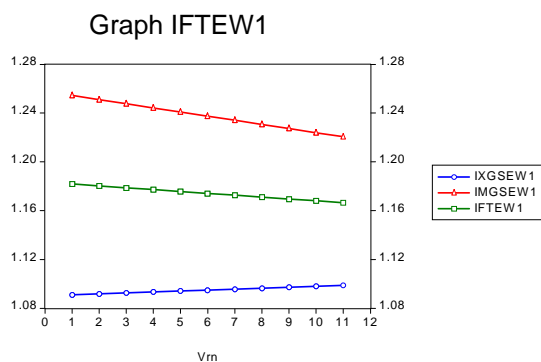
4. The international environment is defined by world trade deflator (WTDsdr) and the index of world trade, volume (IWTc). The macromodel has been successively solved in the following variants:

Table no. IV4

Variant	WTDsdr	IWTc
1	1.009	1.059
2	1.014	1.067
3	1.019	1.075
4	1.024	1.083
5	1.029	1.091
6	1.034	1.099
7	1.039	1.107
8	1.044	1.115
9	1.049	1.123
10	1.054	1.131
11	1.059	1.139

As in previous simulations, the other exogenous indicators do not change. The indicators resulted from WTDsdr series are marked by suffix W1 and those corresponding to variation of IWTc by suffix W2.

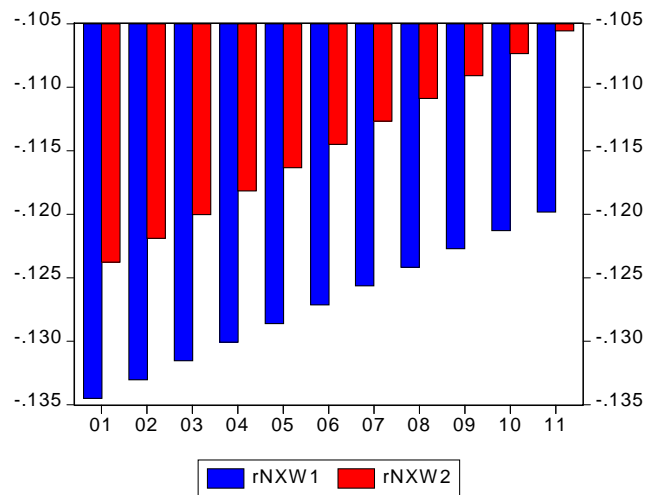
4.1. The foreign trade takes over the most significant influences. These are reflected by indices of export (IXGSE), of import (IMGSE), and of total foreign trade (IFTE). Graphs IFTEW1 and IFTEW2 present them:



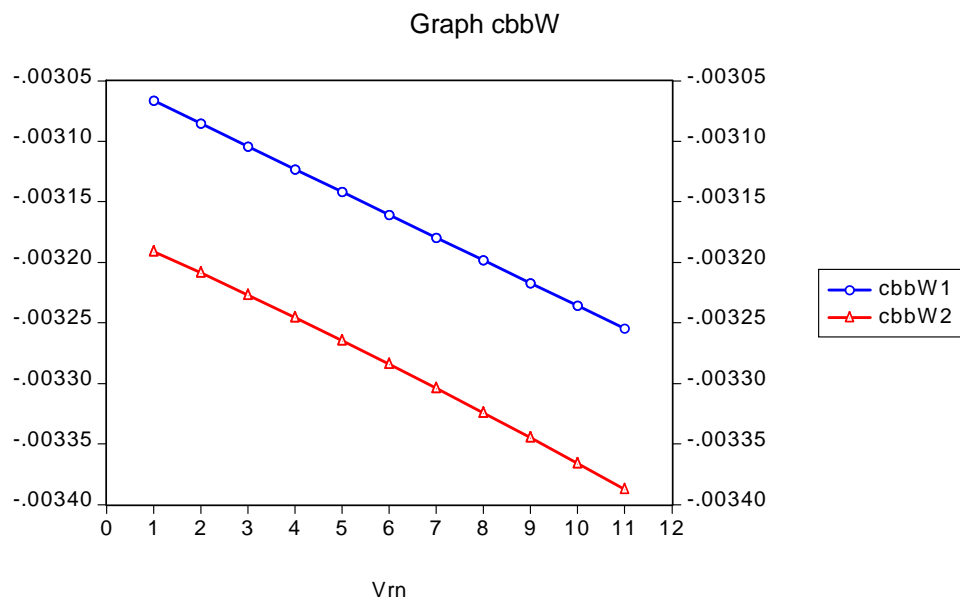
The foreign trade balance (rNX) also improves (Graph rNXW).

Graph rNXW





cbbW). 4.2. Instead, the deficits of the general consolidated budget (negative cbb) accentuate (Graph



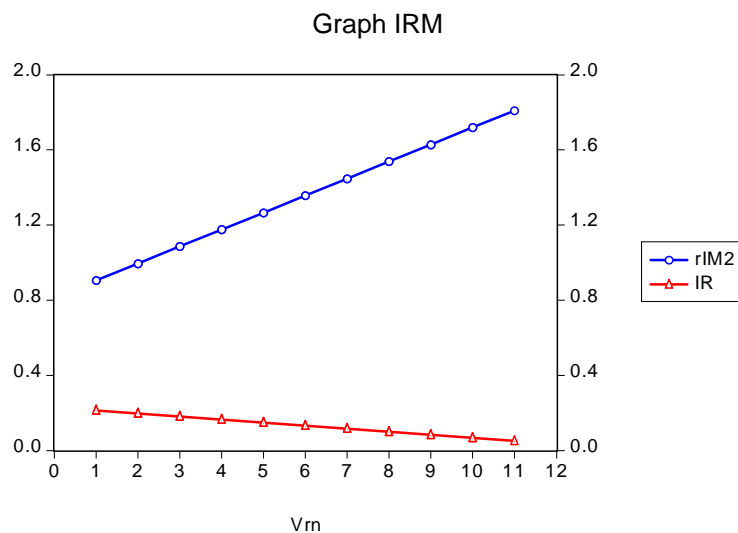
5. The next simulation refers to the money supply (M2S), which is modified as follows:

Table no. IV5

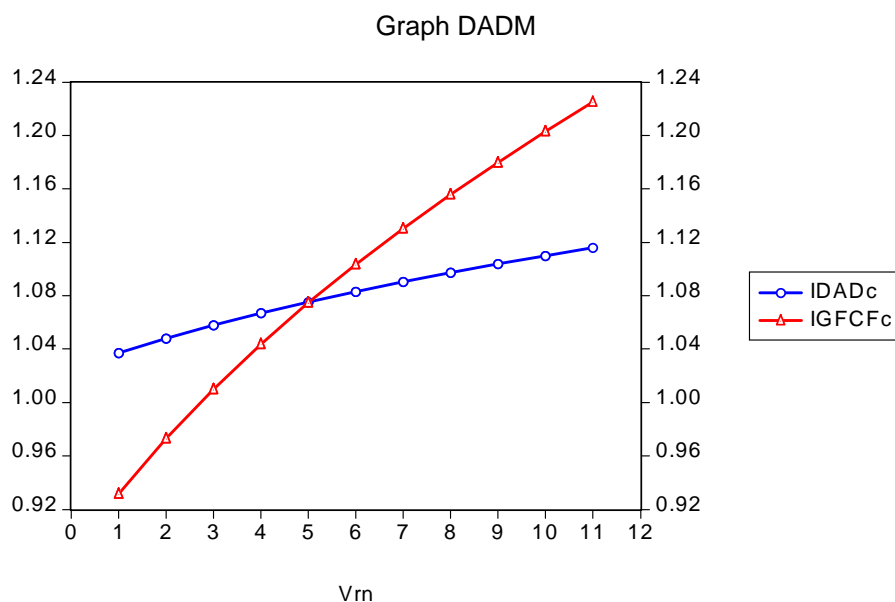
VRN	M2S, bn. RON
1	50
2	55
3	60
4	65
5	70
6	75
7	80
8	85

9	90
10	95
11	100

5.1. The disposable income being fixed, the nominal GDP changes a little. Under these conditions, growing M2S means, in fact, a re-monetisation of economy, which attracts, normally, a reduction of the interest rate. The Graph IRM compares variation of the rate of broad money ( $r_{IM2}=M2/M2(-1)-1$ ) and of the interest rate (IR).



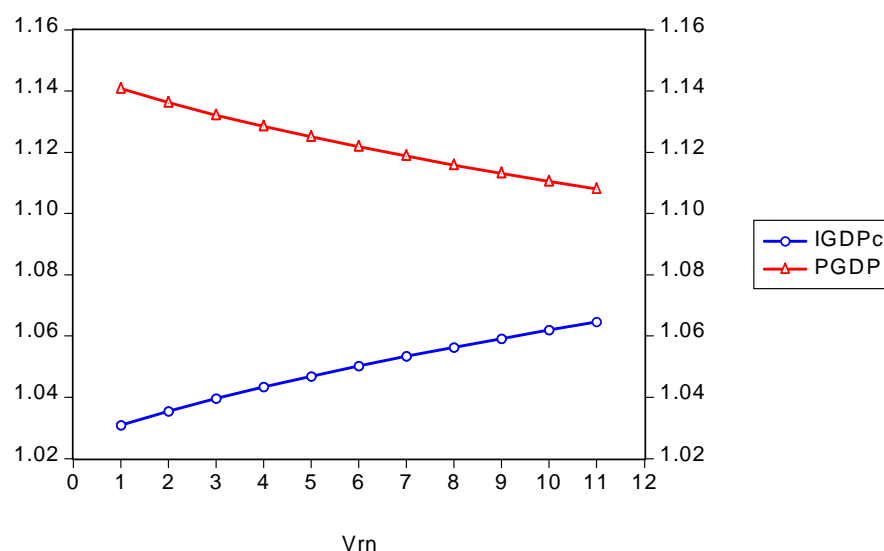
5.2. The relaxation of interest rate stimulates, in real terms, domestic absorption (IDADc), especially the fixed capital formation (IGFCFc), as it is shown in Graph DADM.



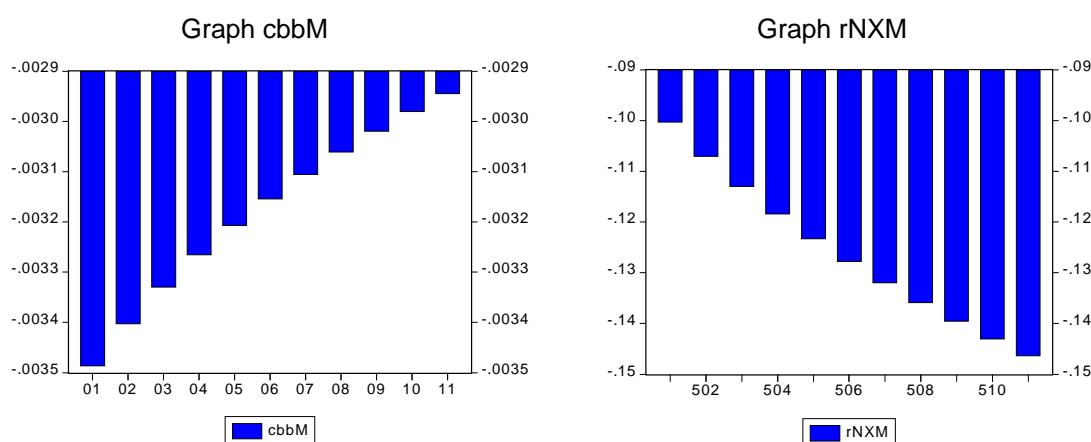
Expanding investments favourably influence not only the quantity of employed production factors, but also their total productivity.

5.3. The economic growth (IGDPc) and disinflation (PGDP) are sustained either by the demand-side circumstances or the supply-side ones (Graph EGM).

Graph EGM



5.4. The small change of public budget deficit (cbb) is associated in this simulation by a deterioration of the external dis-equilibrium (rNX) (Graphs cbbM and rNXM).



6. The previous type of simulations reveals some of the most important behavioural features of the macromodel. They are, obviously, simply illustrative. Other discretionary interventions in the macromodel are also possible, two of them being really interesting.

6.1. Every econometric specification – even in the most fortunate cases - cannot detect all significant factors involved in the determination of the given indicator. Some expert estimates of such hardly visible causes could be useful. For instance, all the people accept that the Central Bank can influence the interest rate or the exchange rate by more subtle tools than those that are already known and officially practiced (as open market operations, change of the reserve requirements ratio, etc). The exports and imports can also be affected by the specific commercial policies, unreductible to computed competitiveness or other variables included in regressions. The intensity of restructuring processes can influence the evolution of unemployment rate.

In such cases, we must not exclude the possibility to attach to the corresponding econometric relationships some exogenous parameters reflecting the effect of supplementary factors (not taken into account in regressions). An advice from well documented specialists in the respective problems maybe extremely useful. The main scenario for 2005-2010 resorted to such a solution.

6.2. The modeller is frequently questioned about the necessary modifications of economic policies in order to achieve a certain desirable result. The current account or public budget balance, the employment,

inflation and other indicators can play such a target-role. In these situations, the system of equations is completed with the intended constraint, adding corrective coefficients to the involved relationships. With the same goal, some carefully chosen objective-functions may also be introduced in the macromodel.

We finish these comments, warning of the risk implied by such operations, namely to transform the rational framework of modelling simulations into gratuitous manipulation. That is why, we must be cautious in accessing them.

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